

How are rating agencies perceived following the US financial crisis? What were their main shortfalls? Insights from academics and professionals

Timothy Sapsford

This research project looks at how academics and professionals with economics or finance backgrounds perceive rating agencies and their shortfalls following the US financial crisis. The paper attempts to fill a gap in the present literature, namely, the lack of qualitative research depicting people's perceptions on the subject matter. The researcher engaged in in-depth interviews to retrieve this data, where four central themes were identified: (i) loss of reputation, (ii) conflict of interest, (iii) complexity and lack of judgement and (iv) lack of competition in the industry. The sample believed that rating agencies' reputation has been negatively affected. Nevertheless, at least some of the interviewees continue to see their overall function in financial markets as positive. The data was inconclusive in regard to whether a change in the business model affected the way rating agencies operate. It showed, however, that the sample believed that conflicting interests were inherent in the current system. The participants also showed their concerns about the complexity of the structured debt and the inability of raters to decipher the risk associated with them. The view that raters lost a grip on reality and lost their sense of judgement was also prevalent. Whilst the majority of participants believed the lack of competition in the industry affected rating agencies' business operations, a general sense for the need for increased competition came about.

1. Introduction

1.1 Background

1.1.1 The US financial crisis and mortgage-backed securities

The financial crisis, which disrupted markets around the world between 2007 and 2009, saw the most severe depression since the 1930s, costing a total of \$120,000 per US household (Atkinson *et al.*, 2013). It is widely accepted that a bubble in real estate prices initiated the US financial crisis. This has been found to stem from the expansionary monetary policies put in place after the dot com bust (Allen and Carletti, 2010; Ackermann, 2008; Brunnermeier, 2009). In addition, other competing factors led many world economies to falter, (with notable exceptions; e.g. Australia) namely global imbalances, market deregulation and excessive leverage (Jickling, 2009).

Another reason was a shift in the banking model from an 'originate and hold' model to an 'originate and distribute' model. Banks would originally allocate loans to borrowers after the latter had met certain criteria of a rigorous screening process, and would subsequently bear the risks of any eventual defaults on those debts. Now, however, loans would be originated and subsequently be put through a process called 'securitisation' (Allen and Carletti, 2010), which meant that they would not be held on the banks' balance sheets, allowing them thereby to bypass Basel's capital requirements (Acharya and Richardson, 2009) and off-load risk (Brunnermeier, 2008). This, in turn, led to a shift in incentives as mortgage originators were more concerned with the number of mortgages they could initiate than with the debtors' ability to repay them (Allen and Carletti, 2010). As house prices were going up at the time, even in the case of default, the collateral the bank would be able to repossess would have become more valuable (Ackermann, 2008).

There was an increase in subprime lending, where people with bad credit histories and low levels of income could be offered a mortgage. The number of new mortgages of this type originated grew from 6% to 15% between 2001 and 2006. Whilst standards fell further with NINJA loans being given out, referring to borrowers with no income, no job and no assets (Ackermann, 2008). The move towards the 'originate and distribute' model ultimately worsened the quality of mortgages that were originated (Purnanandam, 2011).

Securitisation involved pooling together a number of mortgages; this would create a product called a mortgage-backed security (MBS). In turn, this security would pay the holder a fixed income through the payments made towards the interest and principal of the underlying mortgages (Acharya and Richardson, 2009). Collateralised debt obligations (CDOs) were also used in the same manner as MBSs,

here the security consisted not only of mortgages but also other products, such as credit card debt and corporate bonds (Brunnermeier, 2008). These securities were then cut up into tranches of varying risk levels, where those deemed as having a high level of risk paid a higher premium compared to those with a lower level of risk (Acharya and Richardson, 2009). These MBSs were rated by the rating agencies (Patronoy, 2009).

1.1.2 Rating agencies

Rating agencies assign ratings to securities in relation to their probability of default (Cantor and Packer, 1994). This is done through factoring in various different forms of information regarding the issuer, the market, the specific security, and the macroeconomic climate (IOSCO, 2003). These ratings of credit risk alleviate the market from information asymmetry, helping investors by reducing uncertainty and allowing issuers to lower their cost of capital (IOSCO, 2003). Each company has its own rating system, but they are essentially harmonised on a notch basis. For Moody's, these range from the highest rating AAA down to C, whilst for Standard & Poor's and Fitch, they range from AAA to D. (Moody's, 2015; Standard & Poor's Rating Services, 2015; Fitch Ratings, 2014). The higher the rating the agency assigns, the lower the probability of default (Ferri *et al.*, 1999) while a rating of BBB is considered the cut off in terms of investment grade securities (Standard & Poor's Rating Services, 2015). Rating agencies are influential as governmental bodies such as the Securities and Exchange Commission (SEC) only allow money market funds to invest in securities rated AAA and AA (Bahena, 2010). Furthermore, if a security's rating is upgraded, its price increases, whilst if it is downgraded, the price decreases (AII, 2015).

There are only three major players in the rating industry, Moody's, S&P and Fitch (Ferri *et al.*, 1993) and they are dubbed the 'Big Three' (White, 2009). Indeed, 97% of the total market revenue goes to these three companies (SEC, 2012).

The recent history of rating agency performance has not been one to boast about. They were not able to foresee the East Asian crisis and in turn downgraded the countries involved by a more than proportionate amount. This had detrimental effects on their economies as it increased their cost of capital and lowered the amount of foreign capital flows into the respective countries (Ferri *et al.*, 1999). The Big Three also gave an investment grade rating to Enron only four days before it went bankrupt (Hill, 2003; Hill 2009).

More recently, rating agencies have been condemned for giving inflated ratings to securities, which in turn spurred the market for MBSs and increased house prices (Patronoy 2009). Moody's downgraded 54% of the subprime tranches it had rated in 2006 and 39% of those it had rated in 2007. S&P downgraded 44% of those originally rated between Q1 2005 and Q3 2007 and Fitch downgraded 34% for those in 2006 up to Q1 2007 (Hill, 2010). The number of these downgrades can therefore lead one to question the validity of the ratings the Big Three assign to securities. Indeed S&P have now admitted wrong doing and have reached an agreement with the Department of Justice to pay a \$1.375bn fine for defrauding investors who were using their MBS and CDO ratings which were inflated and did not reflect the true credit risk of the underlying securities (Department of Justice, 2015).

1.2 Significance of the research

The significance of this research project is to fill the gap in the literature regarding people's perceptions of credit rating agencies and their respective shortfalls. Furthermore, this research project attempts to link the existing theory surrounding the topic with academics and professionals' views and looks for areas of agreement and disagreement.

1.3 Aims and objectives

1.3.1 Aims

- To understand the perceptions academics and professionals have of rating agencies and their shortfalls following the US financial crisis.

1.3.2 Objectives

- Conduct in-depth semi-structured interviews with a sample of academics and professionals with a background in finance or economics.
- Compare the data collected with existing literature to establish whether the sample's perceptions are in accordance with the relevant theory.

1.4 Structure of the dissertation

This dissertation will be made up of 5 Sections, the first of which has provided the reader with a background to the rating agency industry and to structured debt in addition to having outlined the significance of the research along with the researcher's aims and objectives. Section 2 provides a literature review to the topic of rating agencies. The section will be split up into four sub-sections: (a) The role of rating agencies in the financial crisis, (b) Changing business model and conflict of interest, (c) Complexity and modelling, and (d) Competition. Section 3 will discuss the methodology used to

conduct the study, the in-depth interviews, along with a discussion of the analysis used – thematic analysis. This will be followed by the ethical considerations that were kept in mind throughout the process of conducting the research project. Section 4 will analyse the data collected from the interviews and compare it with the existing literature on the topic of rating agencies. Finally, Section 5 will conclude the research project. It will provide a summary of the findings followed by the limitations of the research study and areas in which it can be developed.

2. Literature Review

2.1 Introduction

This Section contains a critical review of the relevant literature and empirical evidence in regard to the role that rating agencies played in the US financial crisis along with their shortfalls. Due to the scarce academic literature on the topic, newspaper articles and reports have been included as they provide valuable information towards the subject.

2.2 The role of rating agencies in the financial crisis and their reputations

Several academics are of the belief that rating agencies were at the centre of the financial crisis, as the inflated ratings they issued for MBSs spurred the market. This, in turn, led to more MBSs and similar financial products being demanded from the buy-side (e.g., Investment Funds) and consequently supplied by the sell-side (Investment banks), which exacerbated the total amount of losses to investors and banks when people defaulted on their debts (White, 2009; Patronoy, 2009; Patronoy 2010; Utzig, 2010). Others are of a similar view, but don't consider rating agencies as the main culprits in causing the crisis as MBSs were mainly sold to banks, who would have had the skills necessary to determine the risk associated with these products, rather than individual investors. Thus, they were not marketing these securities to investors through inflated ratings (Acharya and Richardson, 2009). Hill (2010) underlines this point: "These instruments were not bought by widows and orphans" (p.598). However, though, Ackermann (2008) blames investors for not being thorough enough when making investment decisions, he does see a point for blaming the rating agencies for not giving ratings of a high quality. Rating agencies have since had their reputation tarnished (Bahena, 2010) leaving some to question the credibility of their ratings (Ryan, 2012). Indeed the CFA Institute (2014) provides evidence that investors have become more wary when looking at ratings for investment purposes.

2.3 Changing business model and conflicts of interest

As White (2009, 2010) recalls, the change in business model from an 'investor pays' principle to one where the issuers pay for a rating in the 1970s gave rise to opportunities for conflict of interest. Rating agencies would be able to guarantee future business by giving more favourable ratings. Although, this may not be applicable to companies wanting ratings for their corporate bonds due to the large number of them, there were only a few investment banks wishing to get large volumes of MBSs rated, creating an incentive to remain on favourable terms with these clients as losing a single one of them would already have resulted in a significant loss of business (Hunt, 2009; White, 2009; White 2010). Patronoy (2009) is also of the view that a change in the underlying business model had had a negative effect on the way rating agencies operated and believes that the loss in reputation from giving incorrect ratings would have been small relative to the profits they would have made. In addition, as the number of securities rated increased dramatically, the resources used per security-issue rating fell. Strobl and Xia (2012) support this argument with empirical evidence, using proxies for conflicts of interest, they find that Standard & Poor's, which adopts an 'issuer pays' model, is more likely to give a higher rating than Egan-Jones Rating Company, which adopts an 'investor pays' business model. Hill (2010) does, however, bring up the point that rating agencies also rate issuers' corporate bonds, which are rarely given the premium 'AAA' rating and that agencies would suffer a loss of reputation if they were to give unjust ratings, thus giving rise to the possibility of a loss of all future business. Whilst the European Commission (2008) refers to how over one tenth of 1,956 investment professionals had seen ratings change because of external pressures (European Commission, 2008). The reason for 51% these were to avoid losing business whilst 17% were to increase business (European Commission, 2008). While the majority of CFA Institute members believe that rating agencies still feel obliged to avoid downgrading or assigning higher ratings than deserved (CFA Institute, 2014). Indeed there are calls for a change in the current business model, although a switch back to the investor-pays model would rid the industry of the aforementioned conflicts of interest there is the ability to be a free-rider in the market. A government subsidy funded by issuers could in turn make sure that credit rating agencies have access to the appropriate resources (Deb and Murphy, 2009).

2.4 Complexity and modelling

Although structured products such as CDOs have differing factors of risk to corporate bonds, they were rated on the same ratings scale (Department of the Treasury 2008; Fender and Mitchell 2005, Hunt, 2009). This was done so that investors would be happy to buy the new complex securities (Fender and Mitchell 2008) without knowing the difference (Department of the Treasury 2008). Indeed, these structured products did not act in the same way as corporate bonds, as they were more

likely to get downgraded during the crisis, in turn, making people question whether they should follow the same rating scale (Hunt, 2009).

The securities that rating agencies were given to rate became more complex (SEC, 2008, Bahena, 2010) and as the complexity of an asset increases, models used to measure their underlying risk become less reliable (Danielsson, 2008). Fender and Mitchell (2005) add to this point in stating that due to added complexity through tranching and pooling, the ratings of CDOs would only give a partial view on the real underlying risks of the security involved. While Sketra and Veldkamp (2009) believe that as an asset becomes more complex there is more room for differing ratings. This creates the incentive for issuers to ratings shop and thus spurs ratings inflation even if they are unbiased.

Brunnermeier (2009) brings up the point that these models were too optimistic and did not count for a systematic fall in house prices to which Danielsson (2008) agrees and lists other modelling failures such as lack of proper documentation and screening. While Hunt (2009) summarises their modelling shortfalls as: not having realistic MBS default risks, lack of historical data to input into models and rating agencies not reacting to the lowering of mortgage standards. Some academics believe that CDO specialists did not even have the expertise to evaluate the risks involved with the assets that were susceptible to default correlation (Danielsson, 2008; Duffie, 2008; Hunt, 2009 Patronoy 2009). There was a lack of understanding of the risks involved with these sorts of securities (Teply *et al.*, 2010).

Rating agencies may have also had a false sense of security in the build up to the crisis as they were 'drinking the Kool-aid', referring to how they were losing sight of the bigger picture (Hill, 2010). Indeed "the structured finance hype caused the [credit rating agencies] to lose their grip on reality" (Bahena, 2010, p.9). Although they are paid to assess the credit quality of securities, many other participants who felt the effects of the financial crisis did not understand the products or foresee the housing bubble bursting either (Hill, 2010). Several market participants lost track of value judgement and were lured by high ratings (Patronoy, 2009).

2.5 Competition

The lack of competition in the rating agency business has been highlighted in the literature (Economist, 2005; Hunt, 2009; Ryan 2012) and several believe that this is the reason for the low quality ratings issued by rating agencies (IOSCO, 2008). Hunt (2009) mentions, how in an environment with more competition, there would be more chance of a competitor producing high quality ratings. This lack of competition has been made about through the fact that only the SEC can decide who can provide

ratings for the creditworthiness of structured debt (Hunt, 2009; The Economist, 2005). Some see this as being a barrier to entry as if you were not given the 'nationally recognised statistical rating organization' (NRSRO) seal you would be side-lined from the ratings business (Hunt, 2009; White, 2009). Although by 2009, the number of NRSROs increased from 3 to 10, only the three biggest rating agencies had a real foothold in the industry, S&P, Moody's and Fitch (White, 2009). In contrary, Hill (2010) believes it is the stickiness of investors which makes the industry so uncompetitive rather than the NRSRO seal, as there should have been a substantial loss of market share from the Big Three after Enron went bankrupt, however this did not happen.

Hill (2009) brings up the point that sometimes securities would need specific rating agencies to rate their security, so there would be no incentive to inflate ratings on these specific securities. Whereas Ryan (2012) is of the belief that there is a duopoly in the market if we disregard Fitch from the Big Three. Thus if 2 ratings are needed for a specific security, S&P and Moody's would not need to compete, Hunt (2009) refers to this situation as a "partner monopoly" (p.132) amplifying this lack of competition.

Hunt (2009) also brings about the point of competitive laxity, where competition would actually lower the quality of ratings by inflating them in order to win clients. Indeed when Fitch entered the ratings market; there was a fall in the quality of ratings (Ryan, 2012). Becker and Milbourn (2011) were able to provide evidence for this by showing that a positive correlation existed between Fitch's market share in the ratings industry and the grade of ratings produced, inferring that an increase in competition would yield higher ratings, inferring lower quality ratings. Furthermore, Strobl and Xia (2012) found that S&P would give higher ratings under a more competitive environment (if they transitioned from being the sole rater for an issuer to not being the sole rater).

While Jones (2008) refers to how Moody's abandoned their diversity score initiative, which would yield lower ratings for securities with pools of the same collateral such as CDOs, and subsequently saw their business in this field prosper.

2.6 Summary

Many believe that rating agencies played a central role in the US financial crisis as their inflated ratings for structured debt instruments spurred the market, in turn amplifying the negative effects when the market was in a downturn. However, these structured debt instruments were not solely bought by retail investors, they were mainly bought by financial institutions who would have had knowledge of

the underlying risks these securities were subject to. Thus the rating agencies' role in the lead up to the recent recession may be limited. With this said, their reputations are believed to have been tarnished following the financial crisis. A change in the underlying business model brought about a conflict of interest, where it would be in the raters' interests to supply favourable ratings to guarantee future business. As securities became more complex, the methods used to determine their underlying risk became less effective, and the respective models came to rely on increasingly less realistic assumptions. Further, there was also a lack of competition in the industry that may have been a reason for the low quality of ratings. However, there is also evidence to suggest that an increase in competition brings forward the idea of 'competitive laxity'.

3. Methodology

3.1 Introduction

The aim of this Section is to provide the information and reasoning behind the methods used to collect the data for this research project. The advantages and limits to semi-structured in-depth interviews and thematic analysis will be discussed, followed by the ethical issues that were kept in mind throughout the entirety of the project.

3.2 Qualitative research

This research project applies a qualitative approach. This method of research was used as it is an inquiry into the way people think and why. The samples are small and the data obtained refers to opinions as opposed to quantitative research, which uses large samples providing measurements (Keegan, 2009). This enables the researcher to answer the question proposed as it is not binary or something one can easily measure, instead the answer is more complex and based on people's perceptions. Furthermore, since the pioneering work of Keynes (1936) the role which perceptions, conventions and expectations play in the financial markets has been largely acknowledged.

3.3 Method

The researcher gathered data through the use of semi-structured in-depth interviewing. A total of eight participants with backgrounds in economics or finance took part. Each one of these interviews lasted around 60 minutes and was either conducted on university campus or over the phone. Following the interview, the researcher transcribed the conversations and analysed them. Thematic analysis was used to analyse the data through coding the transcript to look for relevant themes in order to compare them with the literature that exists on the topic.

3.3.1 Semi-structured interviews

DiCicco-Bloom and Crabtree (2006) point out that semi-structured interviews are normally the sole research method used in order to gather information for a qualitative research project. Semi-structured interviews are a good way to gather intelligence from participants through the use of questions (Longhurst, 2010). They allow the researcher to gather comprehensive intelligence on people's perceptions and on topical issues (Boyce and Neale, 2006). They can yield better information than other research methods such as surveys as the participant, being in an informal environment, may find it easier to share information with you (Boyce and Neale, 2006).

For these reasons, the researcher has decided to conduct their research in such a way; so that they may be able to directly understand the perceptions academics and professionals have in relation to rating agencies and their shortfalls following the US financial crisis.

3.3.2 The sample

Purposeful sampling can be used, where participants have a connection to the research question so that the information gathered from the interview process can be of a high level (DiCicco-Bloom and Crabtree, 2006). Therefore, the researcher has interviewed professionals in the financial services sector along with economic and financial academics. Table 1 illustrates the participants' respective backgrounds, with the list ranging from an ex-hedge fund manager to economic research fellows.

When general themes start to emerge between participants' views, the sample is considered to be of satisfactory size (Boyce & Neale, 2006). For this reason the researcher decided not to put an initial cap on the number of interviews conducted so that they would be able to explore the relevant themes surrounding the topic.

Table 1: Participants' background

Participant #	Participant background
Participant 1	Investment professional at a leading private equity firm
Participant 2	Director of sales at a boutique asset management firm
Participant 3	Principal teaching fellow in accounting and finance at a leading British university
Participant 4	Economic research fellow at a leading British university
Participant 5	Associate partner at a leading investment management firm
Participant 6	Partner at a leading investment management firm
Participant 7	Ex-hedge fund manager
Participant 8	Analyst at a leading financial advisory firm

3.3.3 The questions

Open-ended questions are asked so that participants are able to share their views and experiences (DiCicco-Bloom and Crabtree, 2006). These questions will have been written up prior to the meeting and run through in a conversational setting during the interview (DiCicco-Bloom and Crabtree, 2006; Longhurst, 2010).

In order to assure that the relevant topics regarding the research project are all discussed, the researcher should make sure they consult with the participants beforehand and identify the questions that will be asked during the interview (Boyce and Neale, 2006). When arranging timings for the interviews the researcher was to conduct, they notified the participants of the questions they were looking to ask (Appendix A), so that they would be able to offer information on the context to the interview.

3.3.4 Limits to semi-structured interviews

Interviews are prone to biases (Boyce and Neale, 2006); so steps should be taken in order to keep those at a minimum. I have, therefore, avoided interviewing rating agency professionals to avoid the data collected to be skewed. With this said, it does not allow us to understand the research question from the 'rating agency's point of view'. Interviews are a long-winded research method as the researcher must dedicate time towards interviewing participants and recording the conversation, subsequently transcribing the recording (Appendix B), followed by analysing what was said (Appendix C) (Boyce and Neale, 2006). However, this time consuming process also allows the researcher to gain a better understanding of the data (Braun and Clarke, 2006).

There are other ways to collect qualitative data such as focus groups, where a cluster of participants share their thoughts on a specific topic; these lack, however, the depth of a one-to-one interview and are not structured in a way to gain information from several different participants in a shorter timeframe (DiCicco-Bloom and Crabtree, 2006).

3.3.5 Thematic analysis

Thematic analysis is a way the researcher is able to analyse data they have collected through discovering patterns within it. These patterns relate to groups of similar responses that are relevant to the research question (Joffe and Yardley, 2004; Braun and Clarke, 2006). The researcher reads through the data, in this case the transcripts from interviews and codes them, pointing out interesting snippets of data, which can relate to the research project. Once these transcripts have been analysed with different codes, the researcher then analyses the codes themselves in order to look for general themes among the data collected (Braun and Clarke, 2006). Themes that derive from theory allow the researcher to accept or contest the relevant literature (Braun and Clarke, 2006). Thematic analysis also provides a flexible way to analyse data as it is free from theoretical knowledge and can be used in conjunction with different sorts of theoretical beliefs (Braun and Clarke, 2006).

3.3.6 Limits to thematic analysis

Researches must be weary of invalidating the data as when thematic analysis is used, certain phrases may be taken out of context; also, the repeated presence of codes does not imply greater importance. For example, the repeated code of 'pain' may not imply a greater amount of pain being felt by an individual, but an increased will to talk of the subject (Joffe and Yardley, 2004).

3.5 Ethical issues

Interviewers should keep in mind what repercussions their actions may have as the interview process can impose psychological harm upon the interviewee. Furthermore, they must maintain the anonymity of the participants (Longhurst, 2010) to avoid the dangers that may arise if information of participants comes into the hands of those with differing interests (DiCicco-Bloom and Crabtree, 2006). For this reason, the researcher made sure the participants were conscious of the fact that their identities would be kept anonymous. The researcher should also provide ample information regarding the reason for interviewing the participants along with being given consent from the interviewees (DiCicco-Bloom and Crabtree, 2006). For this reason, the researcher sent an information sheet (Appendix D) and a consent form (Appendix E) to each participant prior to the interview.

3.6 Summary

The researcher has explained the reason for using an in-depth interview method along with thematic analysis in order to gather and analyse data needed in order to answer their research question. The researcher has also kept in mind several ethical considerations, to ensure that their actions have no negative consequences on other parties.

4. Analysis and Findings

4.1 Introduction

This Section will run through the analysed transcripts from the eight interviews that have taken place and compare them with the literature on and theoretical views about the role that rating agencies have played in the run-up to the financial crisis. Four general themes were quite evident, loss of reputation, conflicts of interest, complexity and lack of judgment, along with a general lack of competition in the ratings industry.

4.2 Loss of reputation for rating agencies

Whilst interviewing the participants, it was quite obvious there was a theme of 'loss of reputation' for rating agencies following the US financial crisis. Indeed, seven out of the eight participants were in agreement to the statement in table 2.

Table 2: Sample’s perceptions of rating agency reputation following the U.S. financial crisis

The US Financial crisis has negatively affected the reputation of rating agencies				
Strongly Agree	Agree	Unsure	Disagree	Strongly Disagree
2	5	0	1	0

Interviewee 2 saw their sluggishness in dealing with the problem as a reason for the loss of reputation:

“The rating agencies did not downgrade in advance. They were slow to react to the problem and therefore they have paid the price in terms of a loss of reputation.”

While interviewee 8 stressed that the financial sector has been damaged as a whole:

“The whole of the financial system, including the rating agencies, has been negatively affected.”

Others expressed how the ratings that are now assigned to securities lack credibility, and that they have changed their behaviour in terms of how they use ratings provided by credit rating agencies. For example, interviewee 2 said:

“I still think that people will view their ratings mildly sceptically.”

Interviewee 4 supported this view in saying:

“I am more suspicious now, they got it wrong and they still haven’t got the basics right.”

These views are in accordance to Bahena (2010) - reputations of rating agencies were negatively affected, questioning the credibility of their ratings as Ryan (2012) does. They also complement the CFA Institute’s findings where 67% of its members agreed that investors now look more vigilantly when using ratings to decipher potential investments. With this said, interviewees 5 and 8 still gave credit to the rating agencies, which was something that was not found in the academic literature.

Interviewee 5:

“Whilst rating agencies still perform a valid function there is now more emphasis on the need for our own research to complement their views.”

Interviewee 8:

“They’re still the best around, regardless of the past. They may have messed up, however, they still provide a valuable service to investors”.

Interestingly, interviewee 4, was in disagreement with the general rhetoric, and questioned whether the \$1.375bn fine S&P had to pay (Department of Justice, 2015), changed anything:

“In theory I agree, their reputation has been negatively affected, but in reality, with the power they have, nothing has changed. Rules haven’t changed on their ratings and nobody has done anything about it. Although, yes, they paid \$1.35bn or so, the failure of Lehman Brothers cost the taxpayer around \$300bn. \$1.35bn is peanuts, this is just PR money only to say that they’ve done something. I would rather that they didn’t pay, but had their [business] model restructured instead so that we can avoid something like this happening again in the future”.

All of the participants alluded to the view that rating agencies played a role in the financial crisis, however, not one suggested that they were one of its main causes; thus, disagreeing hereby with the view expressed in the works of White (2009), Patronoy, (2009, 2010) and Utzig (2010), who consider inflated ratings a central cog in the works of the financial crisis, stimulating the market for MBSs. Interviewee 7 went on to suggest how they worsened the impact of the financial crisis without having been, however, its initiators.

“Investors relied on rating agencies more than they should have, however I don’t think it was inflated ratings that caused the financial crisis, although it allowed pension funds etc. to get into the market. The principal players were the leveraged buyers”.

4.3 Conflicts of interest

When the participants were questioned about whether a shift in the underlying business model would change the way credit rating agencies operate, the data obtained was inconclusive, with four agreeing with the statement, one disagreeing and three unsure (see Appendix F). However, all participants expressed doubts over the efficiency of an “issuer pays” business model throughout the interview process and a theme of conflicting interests developed. Interviewee 1 shared the view of the European Commission (2008) in thinking that the current “issuer pays” model leaves room for issuers to push for higher ratings:

"In the end of the day there will always be pressures from companies to get higher ratings".

Interviewee 2 agreed:

"I feel that if issuers are paying, these companies will be putting pressure on the rating agencies in order to get more favourable ratings".

So did Interviewee 4:

"Generally, changing the stakeholders shifts the level of interest towards them. Companies will defend their interests and exercise the power they have in the rating process".

Some even put forward the idea of moving back toward an "investor pays" business model, in hope of ridding the industry of conflicting interests echoing the views of Deb and Murphy (2009) and the majority (52%) of CFA Institute members (CFA Institute, 2014). Interviewee 7 said:

"The rating agencies played both the gamekeeper and the poacher. Investors needed to be protected by the rating agencies, how can they be protected if their interests aren't aligned? They should be paid by investors rather than issuers. They are half-way between civil servants and bankers, they were enticed by the higher levels of compensation they would get from rating these exotic instruments which would make them want to keep the investment banks happy by giving better ratings. The industry should find a way of returning to an 'investor pays' business model".

However, some of participants pointed out the difficulty in adopting a new "investor pays" model, as it gives room for free riders to enter the market. Agreeing with one of White's (2009) reasons for which the credit rating agencies' business model changed in the first place, as due to technological developments, ratings can freely be shared among investors. For example, interviewee 3 said:

"But, how can you pay for a public good, it would be difficult to be paid by investors".

Interviewee 8 was in agreement:

"There should be a move back to the 'investor pays' model, however, the same problems of freeriding would come about, just as they did in pre-1970s".

One participant however, interviewee 6, saw this conflict of interest as being less important in the run up to the financial crisis, although believing that there is a problem with the current business model, they placed more emphasis on the lack of expertise on of the raters:

“The rating agencies failed to identify the risks being taken and gave AAA ratings to CDOs, which turned out to be junk. I would question the relationship between the agencies and the issuers of debt. [...] The move from a subscriber (investor) to an ‘issuer pays’ model occurred in the 1970s, a long time before the recent US financial crisis. Their behaviour did not change, but their analysis of CDS did not work”.

4.4 Complexity and lack of judgment

Overall, the participants saw the complexity of CDOs and the models used to measure their credit risk as being problematic. Indeed, three-quarters agreed to the statement in Table 3. This idea of complexity was a prevalent theme throughout the interviews that were conducted, whilst the theme of a lack of judgment also became clear.

Table 3: Sample’s perceptions on whether there was a problem with the complexity of the securities and the inadequate models used to measure risk

There was a problem with the complexity of the securities and the inadequate models used by rating agencies to measure risk				
Strongly Agree	Agree	Unsure	Disagree	Strongly Disagree
2	4	2	0	0

In accordance with Danielsson (2008), interviewee 1 allured to the idea that there was amplified difficulty in determining the risk associated with these securities as their complexities increased:

“CDOs are very complex, the more complex the product the more complex the modelling. I can imagine they were very difficult to understand, and thus with more complexity the less informed you would be. It is difficult to understand the underlying risk if you do not understand the product”.

Interviewee 4 agreed with this idea, and in support of Danielsson (2008) Duffie (2008), Hunt (2009) and Patronoy (2009), believed that rating agencies lacked the expertise needed:

'The more unknowns you bundle together, the more chance that something will go wrong, this is what was happening and it created a huge lack of information. People didn't have the knowledge to understand the underlying risks in CDOs'.

While Interviewee 8 referred to the lack of understanding that was inherent throughout the financial services industry, supporting Teply *et al.* (2010).

"The securities became so complex that nobody really knew what was in them. This created a flawed process as how can you rate something you don't understand".

A theme that stemmed off this idea of complexity was lack of judgement. Several interviewees took this point of view as they thought that market participants and rating agencies were lured by the profitable CDO business without questioning its long-term reliability and thus 'drinking the Kool-aid' as referred to by Hill (2011).

For example, interviewee 2 and 4 stated they were fuelled by greed and were not using common sense.

Interviewee 2:

"The real problem was that people lost the sight of common sense when it came to the complexity of the securities. You could compare this to the story of Icarus; people were seeking higher and higher returns and just lost sight of common sense until everything came spiralling downwards".

Interviewee 4:

"They were enjoying the fruits of a booming market with a 'don't mess with success' attitude and so were blindly continuing with what they were doing as they were making money and it seemed as if it was working".

While interviewee 1 and 3 said that they couldn't see the inherent risks associated with their actions.

Interviewee 1:

"They were all working in a cloud where they couldn't see what was actually happening."

Interviewee 3:

“As you get into more and more complex markets, you lose the idea of the big picture in terms of calculations. You could get blinded by the models, without thinking of other factors within the market. Complexity is a given, however, basic judgement still needs to be there. Everybody was caught up with the magic that was going on; banks, investors, regulators and rating agencies etc.”

Although interviewee 7 thought the rating agencies used assumptions that were too optimistic in their models, in line with Brunnermeier (2009), they placed more emphasis on investor behaviour:

“At issuance, the ratings and prices may have been more or less correct, but as the crisis unfolded, people who owned these securities didn’t want them anymore, and sold them whether or not the price was in line with the probability of those mortgages defaulting. In fact, most of those mortgages didn’t even default; it was just the behaviour of investors that made the price fall to such a level. The government actually managed to make quite a lot of money when they bought these ‘toxic assets’ from banks and held them until maturity!”

4.5 Competition

Overall, the majority of participants believed that the level of competition in the industry affected the way they operate, as the data shows in in table 4.

Table 4: Sample’s perceptions on whether competition affects ratings

The level of competition within the rating agency industry affects ratings				
Strongly Agree	Agree	Unsure	Disagree	Strongly Disagree
0	5	0	3	0

All but one of the participants agreed with the idea that the rating agency industry was uncompetitive (Economist, 2005; Hunt, 2009; Ryan 2012), for example interviewee 4 stated:

“[...] they ended up having too much power, the barriers to entry in the market were so high that there was an effective oligopoly”.

Interviewee 3 commented:

“There are only about 3 or 4 rating agencies that have a massive share of the market”.

Whilst interviewee 2 echoed the view of the IOSCO (2008) in thinking that the lack of competition could lead to unwarranted ratings. They also brought up the fact that there are measures put in place to limit this behaviour, as referred to by Hill (2010):

“If there is an oligopoly, as is the case for Moody’s, S&P and Fitch, there is potential for the output to be skewed. This manifested itself in terms of higher ratings. However, there is still need for 2 ratings for certain securities”.

While interviewee 1 also brought up the need for 2 ratings, they made the point that these ratings are mostly the same, enhancing this lack of competition as Hunt (2009) did when describing the two biggest rating agencies, S&P and Moody’s as having a “partner monopoly” (Hunt, 2009, p.132).

Interviewee 1:

“There are normally 2 ratings provided for a debt instrument precisely for this reason and there aren’t many split (differing) ratings”.

Several of the participants saw the need for more competition in the industry in order to increase the quality of ratings, agreeing with the theory put forward by Hunt (2009) where increased competition would lead to increased probability of higher quality ratings. For example Interviewee 5 said:

“Competition should have a positive effect on ratings as the quality of their judgments will be scrutinised in a greater fashion driving up performance. Any increase in competition should ultimately drive up the quality of the industry – which is the ultimate aim”.

Interviewee 4 was of a similar view:

“As regulators did not understand what they were doing when rating these CDOs they had no knowledge of whether they were acting efficiently or not. There was a need for other competitors who could figure this out and stop what was happening”.

Interviewee 7, however, was unsure on whether increasing competition would have a positive effect, touching on the theory of competitive laxity (Hunt, 2009):

“Competition did not make a difference with plain vanilla (basic) securities, when they became more complex it made them lower their standards. I’m not sure whether increased or decreased competition would have made the situation better or not”.

Whilst Interviewee 8 was in agreement with Hill (2010) in thinking that the uncompetitive nature of the industry came about through investor stickiness rather than a lack of competitors:

“The lack of competition means that the established firms, e.g. Moody’s, are trusted, people will carry on using them”.

5. Conclusion

The final Section of this dissertation contains a summary of the research findings from the interviewing process. It will also cover the limitations to the research conducted and discuss avenues in which further research can develop and build upon this research project.

5.1 Summary of findings

The researcher has kept in line with his aims and objectives by conducting in-depth semi-structured interviews with eight participants, all of whom had backgrounds in economics or finance. In doing so, he was able to understand their perceptions regarding rating agencies and their shortfalls and compare them with the existing literature surrounding the topic.

Indeed, all but one of the participants shared the view that there has been a loss in reputation for rating agencies following the US financial crisis. With all of the interviewees believing that rating agencies played a role in the financial crisis, some have started to question the validity of the ratings they produce and use them in a more cautious manner following the US financial crisis. Interestingly a couple of participants shared the view that rating agencies are still a valuable source of information regardless of their past performance.

When asked whether a change in their business model could have affected the ratings given to securities, the participants had differing views, thus making it difficult to come to a final conclusion whether it was a significant failure. However, as a whole they identified the failures inherent with this business model and the potential of conflicts of interest. Some participants longed for a shift back to the “investor pays” model, but saw difficulty in adopting it.

The majority of participants saw the complexity and inadequate models used to decipher the risk of MBSs and CDOs as one of the rating agencies' major shortfalls. Several also believed that there was a lack of proper judgement in the rating agency industry where people stopped using common sense.

Finally, when asked whether one of their shortfalls could have been a general lack of competition within the industry, the majority agreed. With this said, three of the eight participants disagreed. The general view that an increase in competition within the market was necessary became evident whilst one participant explained that the uncompetitive nature of the market came about through investor stickiness.

5.2 Limitations of research

Only a small sample was used when collecting the data for this research project, which means that the sample's views may not adequately reflect those of the population. Furthermore, although rating agency professionals were deliberately excluded from the sample in order to eliminate the risk of the bias that their inclusion would inevitably have introduced to the study, this leaves a gap in the research, as their views have not been considered in the researcher's attempt to answer the question.

5.3 Further research

The research can be developed through using a larger sample of participants, so that stronger conclusions can be made surrounding the research question. Furthermore, it would allow the researcher to understand different groups of peoples' perceptions concerning rating agencies' reputations and their shortfalls and compare them with one another.

This research project can act as a building block for further research regarding perceptions of academics and professionals in regards to rating agencies' reputation and shortfalls following the US financial crisis. Furthermore it could work towards a larger research project concerning peoples' perceptions in relation to all the different driving forces of the financial crisis.

Bibliography

AAll. 2015. "American Association of Individual Investors". *How Credit Ratings Affect Bond Valuations*. [Online]. [Accessed: 7th May 2015].

Available at: <http://www.aaii.com/investing/article/how-credit-ratings-affect-bond-valuations?adv=yes>

Acharya, V., and M. Richardson. 2009. Causes of the financial crisis. *Critical Review*. **21**(2-3). pp.195-210.

Ackermann, J. 2008. The subprime crisis and its consequences. *Journal of Financial Stability*. **4**(4). pp.329-337.

Allen, F., and E. Carletti. 2010. An Overview Of The Crisis: Causes, Consequences, And Solutions'. *International Review of Finance*. **10**(1). pp.1-26.

Atkinson, T., D. Luttrell, and H. Rosenblum. 2013. How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis. Dallas Fed Staff Paper. No.20, July 2013. [Online]. [Accessed: 12th December 2015].

Available at: <https://dallasfed.org/assets/documents/research/staff/staff1301.pdf>

Bahena, A. 2010. What Role Did Credit Rating Agencies Play in the Credit Crisis? Global Money, the Good Life, and You. Understanding the Local Impact of International Financial Institutions. [Online]. [Accessed: 2nd February 2015].

Available at: <http://www.colorado.edu/AmStudies/lewis/ecology/rolecreditagencies.pdf>

Becker, B., and T. Millbourn. 2011. How did increased competition affect credit ratings?. *Journal of Financial Economics*. **101**(3). pp.493-514

Boyce, C., and P. Neale. 2006. Conducting In-Depth Interview: A Guide for Designing and Conducting In-Depth Interviews for Evaluation Input. Watertown, MA: Pathfinder International. [Online]. [Accessed: 6th April 2015].

Available at: http://www2.pathfinder.org/site/DocServer/m_e_tool_series_indepth_interviews.pdf

Braun, V., and V. Clarke. 2006. Using thematic analysis in psychology. *Qualitative Research in Psychology*. **3**(2). pp.77-101.

Brunnermeier, M. 2009. Deciphering The Liquidity and Credit Crunch 2007-08. *Journal of Economic Perspectives*. **23**(1). pp.77-100.

Cantor, R., and F. Packer. 1994. The Credit Rating Industry. *Federal Reserve Bank of New York Quarterly Review Quarterly Review*. **19**(12). pp.1-26.

CFA Institute, 2014. Chartered Financial Analyst Institute. Credit Rating Agency Survey: Results – June 2014. [Online]. [Accessed: 4th May 2015].

Available at: http://www.cfainstitute.org/Survey/credit_rating_agency_survey_report.pdf

Daniélsson, J. 2008. Blame the Models. *Journal of Financial Stability*. **4**(4). pp.321-328.

Deb, P., and G. Murphy. 2009. Credit Rating Agencies: An Alternative Model. [Online]. [Accessed: 12th January 2015].

Available at: http://personal.lse.ac.uk/debp/Papers/Ratings_Regulation.pdf

Department of Justice. 2015. Justice Department and State Partners Secure \$1.375 Billion Settlement with S&P for Defrauding Investors in the Lead Up to the Financial Crisis. [Press release]. [Online]. [Accessed: 20th February 2015].

Available at: <http://www.justice.gov/opa/pr/justice-department-and-state-partners-secure-1375-billion-settlement-sp-defrauding-investors>

Department of the Treasury. 2008. Policy statement on financial market developments. [Online]. [Accessed: 4th May 2015].

Available at: <http://fic.wharton.upenn.edu/fic/Policy%20page/presidentworkinggroup.pdf>

DiCicco-Bloom, B., and B. Crabtree. 2006. The qualitative research interview. *Medical Education*. **40**(4). pp.14-321.

Duffie, D. 2008. Innovations in Credit Risk Transfer: Implications for Financial Stability. *BIS Working Paper*. No. 255. [Online]. [Accessed: 14th March 2015].

Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1165484

European Commission 2008. Commission Staff Working Document Accompanying The Proposal For A Regulation Of The European Parliament And Of The Council On Credit Rating Agencies: Impact Assessment. [Online]. [Accessed: 22nd March 2015].

Available at: http://ec.europa.eu/internal_market/securities/docs/agencies/impact_assessment_en.pdf

Fender, I., and J. Mitchell. 2005. Structured Finance: complexity, risk and the use of ratings. *BIS Quarterly Review*. June 2005. pp.67-79. [Online]. [Accessed: 9th March 2015].

Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1967438

Fennell, D., and A. Medvedev. 2011. An economic analysis of credit rating agency business models and rating accuracy. Financial Services Authority. [Online]. [Accessed: 17th March 2015].

Available at: <http://hb.betterregulation.com/external/OP41%20An%20economic%20analysis%20of%20credit%20rating%20agency%20business%20models%20and%20ratings%20accuracy.pdf>

Ferri, G., L.G. Liu, and J.E. Stiglitz. 1999. The Procyclical Role of Rating Agencies: Evidence from the East Asian Crisis. *Economic Notes*. **28**(3). pp.335-355.

Fitch Ratings. 2014. Definitions of Ratings and Other Forms of Opinion. [Online]. [Accessed: 19th February 2015].

Available at: https://www.fitchratings.com/web_content/ratings/fitch_ratings_definitions_and_scales.pdf

Hill, C. 2003. Rating Agencies Behaving Badly: The Case of Enron. *Connecticut Law Review*. **35**(1145). pp.1145 -1155.

Hill, C. 2009. Why Did Anyone Listen to the Rating Agencies After Enron?. *Journal of Business and Technology Law*. **4**(2). pp.283-294.

Hill, C. 2010. Why Did Rating Agencies Do Such A Bad Job Rating Subprime Securities?. *University of Pittsburgh Law Review*. **71**(3). pp.585-608.

Hunt, J. 2009. Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement. *Columbia Business Law Review*. 2009(1). pp.1-74.

IOSCO. 2003. International Organisation Of Securities Commissions. Report on the activities of Credit Rating Agencies. [Online]. [Accessed: 18th February 2015]. Available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf>

IOSCO. 2008. International Organisation Of Securities Commissions. The Role of Credit Rating Agencies in Structured Finance Markets. [Online]. [Accessed: 4th April 2015]. Available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf>

Jickling, M. 2009. Causes of the Financial Crisis. Congressional Research Service. [Online]. [Accessed: 15th April 2015]. Available at: http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1605&context=key_workplace

Joffe, H., and L. Yardley. 2004. Content and Thematic Analysis. In: Marks, D., and L., Yardley. *Research Methods for Clinical and Health Psychology*. London: SAGE

Jones, S. 2008. How Moody's Faltered. Financial Times. 17/10/08. [Online]. [Accessed: 9th October 2015]. Available at: http://www.ft.com/cms/s/65892340-9b1a-11dd-a653-000077b07658,Authorised=false.html?i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2F65892340-9b1a-11dd-a653-000077b07658.html%3Fsiteedition%3Duk&siteedition=uk&i_referer=#axzz3VOZpPHXj

Keegan, S. 2009. *Qualitative Research: Good Decision Making through understanding People, Cultures and Markets*. Great Britain: Koran Page Limited.

Keynes, J. 1936. *The General Theory of Employment, Interest and Money*. London: Macmillan and Co. Limited.

Longhurst, R. 2010. Semi-structured Interviews and Focus Groups. In: Clifford, N. and Valentine, G. *Key Methods in Geography*. 2nd edition. London: Sage Publications.

Moody's. 2015. Rating Symbols and definitions. [Online]. [Accessed: 25th March 2015]. Available at: https://www.moody's.com/researchdocumentcontentpage.aspx?docid=PBC_79004

Patronoy, F. 2009. Overdependence on Credit Ratings was a Primary Cause of the Crisis. San Diego Legal Studies. Paper No. 09-015. [Online]. [Accessed: 17th January 2015]. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1430653

Patronoy, F. 2010. Historical Perspectives on the Financial Crisis: Ivar Kreuger, the Credit-Rating Agencies, and Two Theories about the Function, and Dysfunction, of Markets. *Yale Journal on Regulation*. **26**(2009). pp.431-443.

Purnanandam, A. 2011. Originate-to-distribute Model and the Subprime Mortgage Crisis. *Review of Financial Studies*. **24**(6). pp.1881-1915.

- Ryan, J. 2012. The Negative Impact of Credit Rating Agencies and proposals for better regulation. Research Division EU Integration Stiftung Wissenschaft und Politik German Institute for International and Security Affairs. Working Paper FG 1. [Online]. [Accessed: 19th February 2015]. Available at: http://www.swp-berlin.org/fileadmin/contents/products/arbeitspapiere/The_Negative_Impact_of_Credit_Rating_Agencies_KS.pdf
- Sketra, V., and L. Veldkamp. 2009. Ratings shopping and asset complexity: A theory of ratings inflation. *Journal of Monetary Economics*. **56**(5). pp.278-695.
- SEC. 2008. Securities and Exchange Commission. Summary Report of Issues Identified in the Staff's Examinations of Select Credit Rating Agencies. [Online]. [Accessed: 22nd April 2015] Available at: <https://www.sec.gov/news/studies/2008/craexamination070808.pdf>
- SEC. 2012. Securities and Exchange Commission. Annual report on Nationally Recognized Statistical Rating Organizations. [Online]. [Accessed: 22nd April 2015]. Available at: <https://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep1212.pdf>
- Standard & Poor's Rating Services. 2015. Credit Ratings Definitions & FAQs. [Online]. [Accessed: 4th April 2015]. Available at: <http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us>
- Teply, P., J. Cernohorsky, and Y. Roshwalb. 2010. The Global Crisis: A Hard Lesson Rooted in Theory and Praxis. *International Journal of Arts and Sciences*. **3**(7). pp.313-216.
- The Economist. 2005. Who Rates the Raters? The Economist. 23/05/05. [Online]. [Accessed: 25th January 2015]. Available at: <http://www.economist.com/node/3786551>
- Utzig, S. 2010. The Financial Crisis and the Regulation of Credit Rating Agencies A European Banking Perspective. Asian Development Bank Institute. No. 188. [Online]. [Accessed: 14th February 2015]. Available at: <http://www.fd.uc.pt/~pgon/PDF/aulas/REGULATIONOFRATINGAGENCIES.pdf>
- White, L. 2009. The Credit- Rating Agencies And the Subprime Debacle. *Critical Review: A Journal of Politics and Society*. **21**(2-3). pp.389-399.
- White, L. 2010. Markets, The Credit Rating Agencies. *The Journal of Economic Perspectives*. **24**(2). pp.211-226.
- Xia, H., and G. Stobl. 2012. The Issuer-Pays Rating Model and Ratings Inflation: Evidence from Corporate Credit Ratings. [Online]. [Accessed: 14th April 2015]. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2002186

Appendices

Appendix A – Interview Questions

Interview Questions

- 1) In order of importance, what were the main causes of the US financial crisis and why?
- 2) The US financial crisis has negatively affected the reputation of rating agencies.

A – I strongly agree
B – I agree
C – I disagree
D – I strongly disagree
E – I don't know

Why?

- 3) Has your behaviour changed in terms of how you use ratings provided by rating agencies following the US financial crisis?
- 4) Moving from an 'investor pays' business model to an 'issuer pays' business model has affected the way Rating Agencies operate.

A – I strongly agree
B – I agree
C – I disagree
D – I strongly disagree
E – I don't know

Why?

- 5) The level of competition within the rating agency industry affects ratings.

A – I strongly agree
B – I agree
C – I disagree
D – I strongly disagree
E – I don't know

Why?

- 6) There was problem with the complex models rating agencies used to measure risk.

A – I strongly agree
B – I agree
C – I disagree
D – I strongly disagree
E – I don't know

Why?

- 7) Did rating agencies have any other shortfalls?
- 8) In what way could the rating agencies be reformed for the better?

Appendix B – Interview transcript example

Participant 1

- 1) That's a hard question. I was not working at the time so I can only provide a reflection of what I've learnt through the years. The main cause of the financial crisis was Freddie Mac and Fannie Mae subsidising loans to those who couldn't afford them, spurring investment in the housing market. Of course there were many other steps but the root of the problem was when Bush decided that every American should be able to have a house. This led to a credit bubble not only for people buying houses but also financial institutions. These institutions did not know what CDOs essentially were and what exactly were in them. It is clear that rating agencies were also rating these wrongly. S&P actually settled today admitting that they were mis-rating mortgages to get market share.
- 2) Agree, again there are wider concepts here. They were all working in a cloud where they couldn't see what was actually happening. Yes it has, but not as badly as banks. There was more scrutiny on rating agencies being too aggressive with ratings at the impact of the crisis. We should assume that Moody's would have to deal with a settlement as S&P did as they were the first non-bank to assume responsibility.
- 3) Don't know.
- 4) Don't know. In the end of the day there will always be pressures from companies to get higher ratings
- 5) Agree. There are normally 2 ratings provided for a debt instrument precisely for this reason and there aren't many split ratings.
- 6) Agree. CDOs are very complex, the more complex the product the more complex the modelling. I can imagine they were very difficult to understand, and thus with more complexity the less informed you would be. It is difficult to understand the underlying risk if you do not understand the product.
- 7) Sorry, can't help you with that.
- 8) The solution would be standardised in an ideal world where guidelines would be put in place. However, in reality, because of financing, companies are so financially complex and do not have the same template. It wouldn't work to have guidelines as ratings could end up being misleading. Furthermore, if you can't have a different methodology when rating, you cannot differentiate and do good analysis. You could maybe make them accountable for their ratings but you can't really as ratings are a tool to assist investors. They are free to choose whether they use this tool or not, whilst others can assess the risk themselves, in-house.

Appendix C – Thematic analysis example

The theme of ‘complexity’ is highlighted in green with ‘lack of judgement’ in yellow.

Interviewee 3:

Derivatives are complicated so the models assessing them would be complex. The judgement part of the assessment is not that obvious. As you get into more and more complex markets, you lose the idea of the big picture in terms of calculation. You could get blinded by the models without thinking of other factors within the market. Complexity is a given, however basic judgement still needs to be there. Everybody was caught up with the magic that was going on; banks, investors, regulators and rating agencies etc.

Appendix D – Information Sheet

What was the involvement of rating agencies in the US financial crisis? What were their main shortfalls? A commentary from economic and financial academics and members of the financial services industry

Invitation

You have been invited to take part in a research project. Before you make your decision of whether to take part or not, it is essential for you to understand the reason for which this research is taking place and what will be asked from you. Please read the following document with care and feel free to contact me if anything is unclear or would like additional information.

What is the purpose of the project?

The purpose of this research project is to understand academics’ and professionals’ perceptions of rating agencies and their shortfalls following the financial crisis.

Why have I been chosen?

You have been chosen to be a participant in this research project as you are an economic/financial academic or work in the financial services sector and thus have ample and substantial knowledge in the area of this research project.

Do I have to take part?

You are free to decide whether to take part in this research project or not. If you decide to be a participant in this research project you will be provided with a consent form to sign. If you decide to no longer take part in the research project you may withdraw at any time without having to state a reason.

What do I have to do?

You will be taking part in an in-depth, semi-structured interview over the telephone or in person. This should last about an hour. You will be asked up to 10 open-ended questions.

What are the possible disadvantages and risks of taking part?

This study may lead to the discussion of sensitive material in regards to your views on the rating agency industry, which may lead you to feel uncomfortable.

What are the possible benefits of taking part?

There are no benefits for people participating in this research project, however, hopefully this work will provide an informative perception of the rating agency industry.

Will my taking part in this project be kept confidential? What will happen to the results of the research project?

All the data that will be collected in this research project will be confidential. Your identity will remain anonymous. It is not probable that this research project will be published, if however it were to be, all the details of where and when this project can be accessed will be sent to you.

Will I be recorded, and how will the recorded media be used?

The audio recordings from the interview will only be used for analysis. They will not be used for any other reason without your written permission. Furthermore, no external parties will have access to the audio recordings for this research project.

Contact for further information

If you have any queries or would like any further information, please do not hesitate to get in contact. My e-mail address is: bn12tojs@leeds.ac.uk

Thank you for taking the time to read this information with care.

Kind regards,

Timothy Sapsford

Appendix E – Consent form

Declaration of Consent

I (print name) give consent to participate in data collection as part of Timothy Sapsford’s undergraduate dissertation research at the University of Leeds. The research is focused on academics’ and professionals’ perceptions of rating agencies and their shortfalls after the US financial crisis.

I understand the information provided will be:

- used sensitively and confidentially
- anonymised such that respondents cannot be identified from the final report
- stored in a secure location:
 - o digital data will be stored initially on a password protected USB, and then transferred to secure folder on the university network
 - o hard-copy data will be stored in a locked filing cabinet on University premises
- destroyed after the research is complete.

Participant:

Signed

Dated

Researcher:

Signed

Dated

Research Supervisor:

Marco Veronese Passarella

Leeds University Business School

Maurice Keyworth Building

The University of Leeds

Leeds

LS2 9JT

M.Passarella@leeds.ac.uk

Appendix F – The participants’ perceptions regarding whether a change in rating agencies’ business model affected their operations

Moving from an ‘investor pays’ business model to an ‘issuer pays’ business model has affected the way rating agencies operate				
Strongly Agree	Agree	Unsure	Disagree	Strongly Disagree
2	2	3	1	0
