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Do multiple credit ratings affect syndicated loan spreads?

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ABSTRACT

We analyze whether soliciting multiple ratings leads to lower syndicated loan spreads. Our results document that banks apply, on average, lower spreads to multi-rated firms. This effect depends on the reduction of information asymmetry about borrowers' creditworthiness (information production hypothesis) and on the benefits in regulatory terms (regulatory certification hypothesis). In addition, consistent with the rating shopping hypothesis, we find that banks price the risk that borrowers shopped for better ratings, especially in crisis periods. Our results also hold when considering crisis periods, the unobserved heterogeneity of lenders, the use of rating-based pricing, and adopting a matched sample.

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1. Introduction

Credit rating agencies (CRAs) play a relevant role in the current financial system. They have two main functions: signaling and monitoring. CRAs signal the creditworthiness of the issuer of a financial security to investors (signaling), and, after the security issuance, they continue to monitor the issuer (monitoring). Credit ratings are also extensively used in financial regulations, for instance, to calculate banks' minimum capital requirements and to determine what securities can be purchased by regulated investors.

The ability of CRAs to adequately signal issuers' creditworthiness was heavily criticized, especially after the 2007 financial crisis. In fact, numerous policy solutions have been proposed to mitigate the structural shortcomings of the rating industry that emerged after the crisis (Financial Stability Board, 2010).

A relevant issue of the credit rating industry is the fee structure. The major CRAs are compensated by issuers; therefore, there is a potential conflict of interest because CRAs may assign more favorable ratings to issuers to maintain customer relationships for future contracts. According to CRAs, this potential issue is mitigated by the risk of lost reputation. Since the rating agency business is reputation-based, deliberately inaccurate judgments could damage the trust in CRAs' ratings.

However, also assuming that the CRAs' ratings are accurate, issuers can decide to "shop for better ratings" (Skreta and Veldkamp, 2009). In fact, each CRA has its own model to rate issuers' securities and, consequently, they can disagree on the rating level to assign. In the case of "rating shopping", issuers contact multiple CRAs, but they decide to report only

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the most favorable rating. To mitigate this issue, the Dodd-Frank act requires issuers to report all formally solicited ratings. Unfortunately, issuers could circumvent this rule through informal discussions about credit quality with different CRAs (Owlett and Yu, 2016).

These issues are widely known by market participants. In light of this, many issuers could decide to pay different CRAs to receive and disclose multiple ratings. If a firm receives similar ratings by different CRAs, its security value should be considered less opaque by investors and it should be less subject to the abovementioned issues. Baker and Mansi (2002) show that issuers use multiple ratings to increase the probability of a true evaluation emerging, which could help to ensure the best possible price for their securities. Therefore, multiple ratings should be appreciated by investors and, consequently, should lead to lower borrowing costs for issuers.

However, firms do not obtain financial resources solely through financial markets, but they often rely on the credit market. In particular, syndicated loans provide an alternative to public borrowing for larger corporations (Howcroft et al., 2014). The syndicated loan market is an important source of global corporate finance, since this market exceeds the total annual issuance volume of equity and bond markets (Bosch and Steffen, 2011). In the syndicated loan market, firms borrow financial resources from banks, which have different characteristics compared to other investors (Diamond, 1984). Given their continuous monitoring activity and long-term customer relationship with firms, banks are considered "quasi-insiders" of the firm (Goss and Roberts, 2011) and, on average, they can assess firms' creditworthiness better than other investors.

However, the syndicated loan market has peculiar characteristics compared to the standard bank credit market. In addition to the information asymmetries between lenders and borrowers, we must also consider the information asymmetries between lead arrangers and other syndicate members. The lead arranger acts as a delegated monitor on behalf of other participant ("uninformed") lenders: he is an "informed lender" who is able to assess the borrower's creditworthiness through unobservable and costly efforts. The abovementioned characteristics give rise to well-known problems: a moral hazard problem at the lead arranger level and, at the same time, agency problems involving delegation costs at the syndicate participant level (Sufi, 2007). When borrowers are relatively transparent, the moral hazard problem for the lead arranger is less severe (Chaudhry and Kleimeier, 2015). In this context, multiple ratings could lead to a reduction in information asymmetries and delegation costs within the syndicate members.

Our aim is to verify whether multiple ratings represent a benefit for firms. In particular, we analyze whether multiple ratings lead to lower borrowing costs in terms of syndicated loan spreads.

We find that, on average, banks apply lower loan spreads to multi-rated firms. First, we observe that borrowers who obtain multiple evaluations by different CRAs confirming the same rating level receive lower spreads and larger loans than other firms. Second, our analysis indicates that banks consider the risk of a potential rating shopping by applying greater loan spreads to firms with less than three ratings. In particular, we find that the concern of banks about the rating shopping tendency is greater during crisis periods. Three, we show that the impact of multiple ratings on loan spreads also depends on the use of ratings in the current financial regulation. Given these results, we highlight that banks do not appear concerned about potential credit rating inflation.

Finally, we confirm that our results hold when also considering the unobserved heterogeneity of lenders, the syndicate characteristics, the use of rating-based pricing in syndicate lending, and adopting a matched sample.

Our findings expand the existing literature in different ways. First, we analyze whether multiple ratings affect the spread of loans applied by banks and not the price of financial instruments traded on the market. This element allows us to analyze how more informed lenders evaluate multiple ratings.

In this regard, our work is related to the strain of literature concerning the impact of split ratings on financial markets. Consistent with the results obtained in the bond rating literature (Livingston and Zhou, 2010), our analysis indicates that greater rating dispersion leads to greater borrowing costs. Notwithstanding banks' uniqueness in mitigating information asymmetry and in monitoring their borrowers (Diamond, 1984), we find that rating dispersion appears to affect the syndicated loan market in the same way as they affect the corporate bond market. However, our work is not limited to the effects of split ratings because we investigate how the syndicated loan market reacts to multiple ratings, even in the case of concordant evaluations by different CRAs.

Our results provide relevant insight into the analysis of the behavior of lender banks. Despite their "uniqueness", financial institutions' assessment process does not appear to differ from that of bond investors, at least in the syndicated loan market. In this sense, our findings may suggest that banks do not appear to be more informed about borrowers' creditworthiness than CRAs. We cannot exclude that lead arrangers may have access to more privileged information about borrowers than CRAs, but they might be not able to disclose and share their information to other participants due to the well-known moral hazard and agency problems (Sufi, 2007).

Second, our analysis is related to the literature on the analysis of potential structural shortcomings of the rating industry. Our findings clarify that the potential biases of the rating business connected with the rating shopping tendency and the rating-based regulation significantly affect the behavior and choices of financial institutions.

The remaining part of this paper is organized as follows. In Section 2, we review the related literature and present the research hypotheses. In Sections 3 and 4, we present the data and methodology. We report our main results in Section 5. We present additional robustness checks in Section 6. Section 7 concludes.

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