



Information content of unsolicited credit ratings and incentives of rating agencies: A theory



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ABSTRACT

Unsolicited credit ratings are issued solely at the discretion of rating agencies based on public information. This paper analyzes firms' incentives to solicit credit ratings to signal their quality and rating agencies' incentives to issue unsolicited ratings. Conditions for two types of equilibria are derived. When rating agencies are compensated for the accuracy of ratings under the subscriber-fee scheme, a quasi-separating equilibrium is likely to occur, in which firm quality is revealed through unsolicited ratings. When rating agencies are compensated only for solicited ratings under the issuer-fee scheme, a separating equilibrium results, in which high-quality firms signal through solicited ratings while low-quality firms are revealed through unsolicited ratings. We show that rating agencies have strong incentives to selectively issue unsolicited ratings in order to induce more fee-based solicited ratings under the issuer-fee scheme.

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1. Introduction

The importance of credit ratings to investors and other market participants has increased significantly in recent years, impacting an issuer's access to and cost of capital, the structure of financial transactions, regulatory requirements, and the ability of fiduciaries and others to make particular investments. In the aftermath of Enron and the subprime mortgage crisis, however, rating agencies have been criticized for insufficient analysis of issuers and conflicts of interest in their operation. In particular, previous studies question the accuracy of unsolicited ratings.¹ Some of these studies conclude that rating agencies either provide misleading information or fail to disclose other important facts, thereby undermining the reliability of their unsolicited ratings (Poon, 2003; Poon et al., 2009; Van Roy, 2013). The Japan Center for International Finance (JCIF, 1999) even charges that rating agencies often punish companies who do not solicit ratings by issuing low unsolicited ratings. In particular, JCIF argues that the unsolicited ratings of S&P's are four notches lower than the solicited ratings of Japan Rating & Investment Information (R&I) while the solicited ratings of S&P's are only two notches lower than those of R&I. In contrast, Kraft (2011) suggests that rating agencies cater to the issuer's demand for a more favorable credit risk assessment than is justified by the underlying economics, alluding to the upward biasedness of solicited ratings. Nonetheless, ratings are found to be much more reliable information in predicting corporate default than are macroeconomic factors (Figlewski, Frydman, & Liang, 2012).

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¹ For example, see Poon (2003), Van Roy (2013), Shimoda and Kawai (2007), Behr and Güttler (2008), Poon, Lee, and Gup (2009), and Byoun and Shin (2012).

Facing such criticism, S&P's remarks in a press release (on March 18, 2005) that "initiating unsolicited ratings without the request of the issuer is subject to the adequacy of publicly available information, and therefore is limited to public companies, and the absence of any legal or regulatory impediments." The agency adds that "to assure consistency and transparency of unsolicited ratings process, S&P's defines meaningful credit market or investor interest generally based on a certain borrowing or issue size." [Moody's \(1999\)](#) argues that its unsolicited and solicited ratings have equal value as all of its ratings are based on sufficient public or inside information. Moody's adds that it publishes unsolicited ratings to protect investors from "rating shopping," which occurs when issuers shop among various rating agencies for the highest ratings.

The findings in [Banner, Behr, and Güttler \(2010\)](#) suggest two reasons for lower unsolicited ratings relative to solicited ratings: i) a self-selection of high quality companies into the solicited rating status and of low quality firms into the unsolicited rating status; and ii) strategic conservatism of rating agencies. Moreover, [Byoun and Shin \(2012\)](#) document that there are significant negative market reactions to unsolicited ratings. Then, why do firms choose not to solicit ratings considering the value lost when facing unsolicited ratings? What incentives drive rating agencies to issue unsolicited ratings? These are key questions in understanding the nature of and the controversy over unsolicited ratings. Thus, we develop a theoretical model to answer these questions.

We particularly focus on understanding the impact of a rating agency's compensation scheme on its rating decisions. A number of nationally recognized statistical rating organizations (NRSRO) are often criticized for the conflict of interest created by the industry's predominant compensation scheme in which issuers of securities pay the rating agencies for their ratings. In 2006, Congress established the Securities and Exchange Commission (SEC) oversight over NRSROs, and recently enhanced this authority through the Dodd–Frank Act which requires the SEC to consider alternative means for compensating rating agencies such as random selection of a rating agency to issue an unsolicited rating for an issuer (a section 15E(w)). Our model provides insights into how different compensation schemes affect a rating agency's decision on unsolicited ratings.

Our model first analyzes a firm's policy of releasing information through the rating agency under alternative rating-fee schemes. We assume that two types of firms exist—"good" and "bad"—and that there is information asymmetry between insiders and market participants. A rating agency is an information specialist that is able to obtain and process information with the lowest cost. An interesting aspect of the model is that it also allows information asymmetry between the rating agency and the issuing firm. Thus, the main task of the rating agency is to reduce the degree of asymmetric information between firm insiders and outside investors within its constraints. We develop the conditions for two equilibria and then connect each of these equilibria to the rating agency's incentive under alternative rating-fee schemes.

The results show that when a rating agency delivers accurate information by issuing a rating for every firm regardless of whether or not the firm solicits, there is no distinction between solicited and unsolicited ratings. Accordingly, firms have no incentive to signal. This condition generates a quasi-separating equilibrium in which unsolicited ratings reveal each firm's quality.

When unsolicited ratings are less informative, there is an improvement in the probability of being rated as safe when good firms solicit ratings. This condition generates a separating equilibrium in which good firms obtain higher value by signaling their quality through solicited ratings, while bad firms choose not to mimic the signal because they obtain lower value by making false signals (relative to doing nothing). Thus, in the separating equilibrium, high-quality firms signal through solicited ratings while low-quality firms are revealed through unsolicited ratings.

We next analyze a rating agency's incentive and resultant equilibria. In the subscriber-fee system, the rating agency's main revenues are subscription fees paid by subscribers to the rating publication. Thus, the agency is compensated for all firms rated and the agency's payoff depends on the accuracy of information conveyed by the ratings, whether or not they are solicited. We show that the rating agency's concern for reputation mitigates its incentive to shirk on collecting and processing information regardless of solicitation by issuers. Accordingly, there is less distinction between solicited and unsolicited ratings under the subscriber-fee system. Thus, the subscriber-fee system fosters the quasi-separating equilibrium.

The rating agency's incentive and the information contents of solicited versus unsolicited ratings change under the issuer-fee system in which the agency is paid by bond issuers. We show that the issuer-fee system creates an incentive for the rating agency to put forth less effort to collect and process information regarding firms relative to the subscriber-fee system and to suppress some information on non-soliciting firms. In particular, given its discretion on unsolicited ratings, the rating agency will issue unsolicited ratings of low-quality firms, suppressing unsolicited ratings for high-quality firms. Thus, lower unsolicited ratings relative to solicited ratings in and of themselves do not necessarily indicate bias. Rather, our model suggests that the rating agency strategically issues unsolicited ratings in order to mitigate a free-rider problem. Our model further suggests that the rating agency's incentive under the issuer-fee system may improve if the solicitation process enhances the information quality carried by solicited ratings and/or if the rating agency bears penalties for inaccurate ratings.

[Fulghieri, Strobly, and Xia \(in press\)](#) develop a dynamic rational expectations model to examine why credit rating agencies issue unsolicited ratings and why unsolicited ratings are lower than solicited ratings. Their results suggest that the monopolistic agency trades off a higher short-term profit from selling inflated ratings to low-quality issuers against a lower long-term profit associated with a reduction in its reputation. Our study complements their results. In particular, our model is based on firms' signaling decision through credit ratings and ratings agencies' incentives under different pay schemes. Accordingly, our results do not require a monopolistic rating agency or rating inflation. Moreover, we provide insights into the effect of rating agencies' competition on the overall ratings quality.

Our study is also related to the literature on a firm's information release policy that advocates firms' release of information on the grounds that it reduces information duplication (e.g., [Diamond, 1985](#)). In this sense, the rating agency aggregates private and public information and transmits this information to the market through credit ratings. In particular, our study contributes to the literature in the following ways. First, our model shows that a firm's decision on the solicitation of a credit rating is an important signaling mechanism. Second, the apparent divergence between solicited and unsolicited ratings can be attributed to the current issuer-fee

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