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Rating shopping and rating inflation in Israel

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ABSTRACT

Firms may exploit the option of choosing among different rating agencies in order to pick the highest rating offered. This possibility, known as rating shopping, is relatively limited on the US corporate bond market because the two main rating agencies (S&P and Moody's) rate virtually all large bond issuers. In this study, we use the data on corporate bond ratings assigned by two Israeli rating agencies affiliated with S&P and Moody's during the period 2004–2012. We show that while one agency (Midroog) systematically assigned higher ratings, the ratings of the other agency (S&P-Maalot) were inflated due to rating shopping. However, despite the many features that encourage rating inflation, the resulting distortion was relatively small (one notch). This may be a fair price for maintaining a competitive rating industry.

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1. Introduction

Ratings of structured bonds significantly deteriorated during the 2007–2008 crisis, much more than those of corporate bonds (Benmelech & Dlugosz, 2009). Rating agencies have been criticized in the past for lagging behind markets or for malfunctioning in specific crises.^{2,3} This time, however, the criticism took a new direction, with rating agencies now accused of using two harmful strategies that inflated ratings: deliberately lowering rating standards (rating catering) and allowing rating shopping.

The accommodation of these strategies within the perception of rating agencies as certifiers that extract value from reputation is not straightforward. Since the crisis, many theoretical studies have attempted to suggest models that accommodate strategic rating inflation, among them Skreta and Veldkamp (2009), Sangiorgi, Sokobin, and Spatt (2009), Fulghieri, Strobl, and Xia (2014), Sangiorgi and Spatt (2012), Bolton, Freixas, and Shapiro (2012), Opp, Opp, and Harris

(2013), and Bar-Issac and Shapiro (2013). These studies pointed to the elements that foster strategic lowering of rating standards (rating catering) and the conditions that facilitate rating shopping. Rating shopping is seen as more prevalent in complex and opaque securities (where there is a greater tendency for disagreement among rating agencies), when rating agencies do not adopt a policy of unsolicited ratings, when shadow rating (indication on possible rating) is relatively cheap, and when investors or regulators ignore the distortions of rating inflation. Among the conditions that encourage rating catering are boom periods in the bond market and the ignorance of investors or regulators regarding shifting standards.

A report by the Basel Committee on Banking Supervision (2000) estimated over 130 rating agencies worldwide and White (2002) mentioned over 30 rating agencies in developing countries, mostly national in their focus. Emergence of local rating agencies is associated with an attempt to develop a local public debt market. However, there is no exclusive model for rating industries and small economies may choose other model than the one employed in developed capital markets. The Basel committee reported that rating agencies may choose different rating policies (solicited vs. unsolicited ratings) or apply different revenue models (issuer-pay model vs. investor-pay model).

In this paper, we use data from the Israeli corporate bond market during the period 2004–2012 to examine the presence of rating shopping and rating inflation. The conditions in this market during the sample period were consistent with many of the elements necessary for rating shopping and rating inflation. For example, it is clear that this

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² Allegations of ratings lagging behind markets nurtured a huge body of literature that examined the information value of rating announcements. A brief summary of many of these studies appears, for example, in Galil and Soffer (2011).

³ Such financial crises include among others the East Asia financial crisis (1997) and the Enron (2001) and Worldcom (2002) bankruptcies. Rating agencies also tend to assign lower unsolicited ratings than solicited ratings (Banner, Behr, & Güttler, 2010).

period can be considered a boom period. The market value of corporate bonds traded on the Tel-Aviv Stock Exchange (TASE) grew from 21.5 billion NIS (approximately 6 billion USD) at the end of 2003 to 305 billion NIS (approximately 87 billion USD) at the end of 2013.⁴ This growth was accompanied by growing competition between two local rating agencies: S&P-Maalo, which has been in operation since 1991, and Midroog, which was established only at the end of 2003. While these agencies were in one way or another affiliated with the two major global agencies (S&P and Moody's), they did not fully adopt their standards. On the one hand they adopted the issuer-pay model, while on the other hand they relinquished the unsolicited rating policy. They also allowed issuers to withdraw from the rating process prior to final approval of the shadow rating and payment of a significant part of the rating fee.

The motivation of this paper is twofold. The first is the examination of the consequences of rating agency competition. The empirical literature on this issue is scarce and somewhat inconclusive. [Becker and Milbourn \(2011\)](#) did not find support for rating shopping but discovered that competition from Fitch had lowered the overall rating quality of Moody's and S&P ratings through rating inflation. [Kisgen and Strahan \(2010\)](#) found some evidence consistent with rating catering in that a new rating agency issued more optimistic ratings. [Bongaerts, Cremers, and Goetzmann \(2012\)](#) found some evidence of rating shopping near the investment-grade boundary. The Israeli rating industry can demonstrate an extreme scenario and the overall rating inflation may indicate the upper bound distortion that may arise due to competition among rating agencies.

The second motivation of the paper is the evaluation of the state of the rating industry in Israel. We wish to explore whether and to what extent local ratings in Israel are inflated. With this respect, the outcome of this paper may serve investors, risk-managers and policy-makers in the Israeli capital market.

We investigate whether ratings in Israel are inflated due to rating shopping and the lowering of rating standards?⁵ We use several methods to address this question. First, we simply compare ratings granted by the two rating agencies to firms with dual ratings. During the sample period (2004–2012) 200 firms were rated by at least one rating agency and only 46 firms obtained ratings from both rating agencies. Interestingly at the time of obtaining the second rating, 20 of these 46 firms were rated higher by Midroog, and no firm was rated higher by S&P-Maalo.

Our second method is similar to that of [Benmelech and Dlugosz \(2009\)](#) and [Griffin, Nickerson, and Yongjun Tang \(2013\)](#).⁶ This method relies on the following notion. Rating shoppers take advantage of errors in risk assessments by rating agencies. In time, new information corrects these previous errors, and therefore ratings that were inflated due to rating shopping should have a greater tendency to be downgraded. And indeed, we discover that after controlling for other explanatory variables, firms rated exclusively by S&P-Maalo had a greater tendency to be downgraded and a lower tendency to be upgraded compared to those rated by both rating agencies.

Our last method relies on estimation of ratings by using accounting data. We consider firms that remained with a single rating and test whether the waived ratings would be on average lower than the actual ratings. The answer is positive for both those that stayed with the S&P-Maalo ratings only and for those that stayed with Midroog only. This result is consistent with inflation of S&P-Maalo ratings due to shopping and a shifted scale by Midroog.

This study contributes to the literature by providing empirical evidence for rating shopping and shifted rating scales on the corporate bond markets. Rating shopping on the US corporate bond market was

only documented for firms near the investment-grade boundary by [Becker and Milbourn \(2011\)](#). The scarcity of rating shopping on the US market stems probably from the policy of unsolicited ratings. In the absence of such policy, as effective in Israel and probably on other bond markets, rating shopping prevails. It appears that the need for maintaining a good reputation does not discourage rating agencies from undesirable strategic behavior. With this respect, our findings conform to the findings by [Benmelech and Dlugosz \(2009\)](#) and [Griffin et al. \(2013\)](#).

Our paper also contributes to the literature by measuring the overall distortion caused by rating shopping. The growing theoretical literature demonstrates the presence of rating bias under various conditions, but it does not evaluate the severity of the problem. Our analysis reveals that the resulting distortion due to rating shopping appears to be relatively small. While the Israeli rating industry has too many features that encourage rating shopping and rating catering, the resulting rating inflation is approximately one notch only. This may be a fair price for maintaining a competitive rating industry. We believe that this finding may contribute to the ongoing debate concerning the desired level of competition in the rating industry.

The remainder of the paper is organized as follows. [Section 1](#) provides a literature review. In [Section 2](#) we describe the credit rating market in Israel. [Section 3](#) describes the data. [Section 4](#) outlines our methodology. The results are presented in [Section 5](#), and [Section 6](#) concludes.

2. Literature review

In the wake of the recent financial crisis, a line of theoretical studies has tried to explain the failure of ratings in assessing the credit risk embedded in structured assets. [Skreta and Veldkamp \(2009\)](#) developed a model that allows issuers to shop for ratings. Rating disclosure is not mandatory, and issuers can observe multiple ratings and disclose only the one most favorable for them. The researchers showed that a combination of increase in asset complexity and the ability of asset issuers to shop for ratings can produce rating inflation. The more the rating methodology involves variety, the more incentives issuers have to shop for rating. For simple assets, agencies issue nearly identical forecasts. Asset issuers then disclose all ratings because more information reduces investor uncertainty and increases the price investors are willing to pay for the asset. For complex assets, ratings may differ, creating an incentive to shop for the best rating.

[Sangiorgi et al. \(2009\)](#) also claimed that in the case of considerable heterogeneity in views, the issuer selects the ratings that are the most positive. They showed that higher costs for obtaining indicative ratings and regulatory mandates to charge fees for obtaining these ratings reduce the extent to which such ratings are obtained, thus decreasing the average published ratings.

[Sangiorgi and Spatt \(2012\)](#) used a rational expectations model in which the issuer of a financial instrument purchases credit ratings in order to provide useful information to investors and attract investor demand. They showed that some equilibria exist in which rating shopping occurs and rating inflation arises. [Bolton, Freixas, and Shapiro \(2012\)](#) also developed a theoretical model that explains fundamental distortions in equilibrium with respect to ratings. They showed that competition among rating agencies facilitates rating shopping among issuers and reduces market efficiency. Rating agencies also tend to inflate ratings during boom times, when investors are more trusting and the risk of reputation damage is lower. [Bar-Issac and Shapiro \(2013\)](#) provided a model in which rating accuracy changes over the business cycle. Their model predicts that during boom periods rating agencies inflate ratings in order to exploit their reputation value, while during recessionary periods they increase rating accuracy to augment their reputation. Their results also hold in a competitive rating market.

⁴ Tel-Aviv Stock Exchange (TASE) statistics available on TASE website.

⁵ It should be noted that rating inflation may also be caused by market timing. However, our relatively short sample period does not allow us to address this possibility.

⁶ [Griffin et al. \(2013\)](#) used this analysis to identify rating catering rather than rating shopping.

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