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The importance of conflicts of interest in attributing sovereign credit ratings

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A R T I C L E I N F O

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A B S T R A C T

Credit rating agencies (CRAs) have been in the regulator's spotlight since the subprime crisis occurred and they remain under criticism due to suspected conflicts of interest that could arise from clients soliciting a rating. The aim of this paper is to contribute to the current discussion on regulatory failures in CRAs' activities by testing the existence of a bias in CRAs' assessment due to conflict of interest. More specifically, we examine whether the solicitation of a rating by a sovereign affects the grade provided by rating agencies. Our empirical results, which are based on a two-step ordered probit for a large set of emerging and industrialized countries, address the issue of self-selection bias for ratings attributed by Standard & Poor's in 2013 and suggest that unsolicited ratings are higher than solicited ones, which goes against the traditional argument of conflict of interest, namely the "blackmail" hypothesis, and supports the idea that CRAs attach an important weight to their reputation in attributing sovereign ratings.

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"No response to the crisis would be effective without addressing the role played by rating agencies"
(Luis A. Agilar, S.E.C. Commissioner, July 2014)

"It was not in the short term economic self-interest of either Moody's or S&P to provide accurate credit ratings . . .because doing so would have hurt their own revenues"
(Report by the Senate Permanent Subcommittee on Investigations, 2011)

"The fact that many countries pay for the rating service they receive may raise concerns with regard to conflicts of interest inherent in the issuer-pays model"
(European Commission, November 2010)

1. Introduction

The primary function of credit rating agencies (CRAs) is to provide a reliable assessment of the creditworthiness of borrowers. In financial markets characterized by information asymmetry, this role is crucial because bond issuers need to provide potential investors with signals attesting their good quality (Spence, 1973). The role of CRAs in global financial markets as financial gatekeepers has increased dramatically over the past decades, peaking at 3.1 million of outstanding credit ratings attributed by NRSROs[1] in 2008 to decrease slightly to 2.5 million in 2012.[2] Three dominant international credit rating agencies – Standard & Poor's, Moody's and Fitch – which assess the creditworthiness of companies and countries hold an average of over 96% of the annual market share.[3] Each of the three operate on an issuer-pays model, which means that institutions issuing debt securities aiming to provide additional guarantee to the market about the product quality have often to pay a fee to the agency to be rated.

The debacle of the financial and sovereign debt crises with abysmal performance of rating agencies have one after the other

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[1] Nationally Recognized Statistical Rating Organisations (NRSROs) are credit rating agencies (CRAs) registered by the SEC as "market recognized credible rating agencies" (SEC 7-12-2003).

[2] Number of outstanding credit ratings attributed by NRSROs: 2638094 (2007), 3123748 (2008), 2905824 (2009), 2816599 (2010), 2611582 (2011), 2504584 (2012) (Annual Report on NRSROs, SEC).

[3] SEC Annual Report, December 2013.

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called into question the widespread reliance[4] on ratings, urging to rethink the business model of credit rating agencies and the suitability of the regulatory framework designed to guarantee the good functioning of the system. Since then, there is much discussion amongst regulators, policymakers, practitioners and academics about the measures that must be taken to make rating agencies more accountable, rating processes more transparent and to eliminate the risk of conflict of interest. Progresses in that direction however have been slow. As noted by former Pennsylvania congressman, Paul Kanjorski, who was involved in the elaboration of the credit rating section of the Dodd–Frank Act. "The change has been minuscule." "[And] I have to be honest. It was the most disappointing section in the bill."

Against this background, more is certainly needed from the academic community to help revamping the regulatory framework surrounding credit rating agencies. This paper offers to feed the discussion on rating agencies practices by shedding light on one important aspect of the debate: the existence of conflicts of interest in the sovereign bond debt market and more specifically the impact of rating solicitation from sovereigns on the CRAs' assessment.

Over the last decade, credit ratings regulation has been remolded in response to the challenge of regulatory failures as well as social pressures resulting from the occurrence of the recent subprime crisis. The opacity surrounding the elaboration of ratings has raised concerns about the existence of potential biases in the rating assessment process (Benmelech and Dlugosz, 2009) leading to sharp criticism of CRAs by governments and the general public (United States Congress, 2008; European Securities and Markets Authority, 2013). After being blamed for favoring boom-bust cycles during the Asian crisis (Ferri et al., 1999) and for attributing a favorable rating to institutions that turned out to be insolvent during the 2008 financial turmoil (Benmelech and Dlugosz, 2009), CRAs are now being denounced for their early downgrades of sovereign ratings and the likely threat that such downgrades represent for the economic recovery particularly in the USA and in Europe (Staikouras, 2012). Therefore, in line with the G20 objective of leaving no area of financial markets unregulated,[5] policymakers have adopted a new regulatory framework with the aim to enhance the transparency and the accuracy of the credit rating process. The main principles guiding the new wave of regulation initiated by the Credit Rating Agency Act of 2006 in the US are listed in the "IOSCO[6] statement of principles regarding the activities of credit rating agencies" (9-25-2003). Among these principles, our paper focuses particularly on the question of independence of CRAs and concerns regarding conflicts of interest (Baker and Mansi, 2002; Bolton et al., 2012) that may arise in the issuer-pays model (White, 2010). An institution soliciting a rating, i.e. meaning that the institution in question is willing to pay a fee to receive a rating, could receive a better creditworthiness evaluation than if it had not solicited the rating. The better creditworthiness evaluation of a soliciting institution could result either from the larger set of information put at the disposal of the evaluating CRA[7] than in the case of a non-soliciting institution – the evaluation here relying on public information only – or for commercial reasons.[8] Conflicts of interest may arise in the latter case and can make market participants question the reliability of CRAs' ratings (Poon and Firth, 2005; Poon et al., 2009; Bannier et al., 2009; Fulghieri et al., 2013). The question of the impact of solicitation of CRAs' creditworthiness evaluation is well documented in the case of corporate ratings (Poon and Firth, 2005; Poon et al., 2009). To the best of our knowledge, the issue has not been addressed yet for sovereign ratings despite the overwhelming interest attached by governments to upgrades or downgrades of their ratings and their pivotal role in financial markets as they are used as a benchmark against which the credit risk evaluation of corporations, banks or other public entities located in a given country should be compared (Gaillard, 2009; Williams et al., 2013; Borensztein et al., 2013). The existing gap probably stems from the lack of reliable data on country's solicitation, preventing to extend the analysis on corporates to sovereigns. In 2009 though, EU regulatory authorities imposed on CRAs to increase their transparency with respect to different aspects of their policy including whether ratings are solicited or not.[9] Because of delays in the implementation of the reform, data only became available to the general public for some agencies two or three years later. Using this opportunity for identification purposes, our main objective in this paper is to examine whether conflicts of interest exist in the process of sovereign ratings determination and more generally whether or not there is a link between rating solicitation and the final rating. To do so, relying on Standard & Poor's data for 2013, we carry out a two-step ordered probit analysis taking into account the sample selection bias with its origin in the decision to solicit a rating or not. For this empirical analysis, we pay a particular attention to find compiling instruments for the solicitation.

Our results indicate that unsolicited sovereign ratings tend to be higher than solicited ones, advocating then for the rejection of the so-called "blackmail" hypothesis according to which CRAs reward soliciting institutions with a higher rating. In other words, conversely to the conflict of interest's argument, CRAs do not seem to provide better ratings in exchange of a fee for their evaluation work. Rather, solicitation appears to lower the rating given to a country, which supports the reputation argument that CRAs tend to minimize the risk of providing a good rating to a country that may default in the future.

The remainder of the paper is organized as follows. Section 2 presents the literature on sovereign ratings determinants and discusses the hypotheses concerning the impact of solicitation on the ratings attribution process. Section 3 presents the data and the methodology underlying our empirical analysis. Section 5 examines results and Section 6 provides the conclusion.

2. The literature

This section is divided in two parts: the first part presents an overview of the literature on the impact of ratings and their determinants and the second focuses more specifically on the role of solicitation in the rating attribution process as well as on the conflict of interest issue.

2.1. The impact of sovereign ratings and their determinants

The academic literature on sovereign ratings has thus far attempted to address two main questions: What is the impact of sovereign ratings on financial markets, and are the determinants

[4] Illustrating this is the ECB's collateral policy that relies among other factor on the rating of the sovereign having issued the bond (ECB Collateral Policy, www.ecb.europa.eu/paym/coll/html/index.en.html).

[5] In particular, the G20 Declaration on Strengthening the Financial market of April 2009 states than CRAs should be subject to regulatory oversight by the end of 2009.

[6] International Organization of Securities Commissions.

[7] Contractually, the solicitation involves regular meetings with the CRA as well as information sharing. While this argument is likely to play a significant role in the case of corporate bonds, it seems far less relevant for sovereign bonds as the assessment is mainly based on public information such as the macroeconomic development and the financial and institutional environment.

[8] For a complete review of the literature on the microeconomic analysis of the sources of conflict of interest for CRAs see Bolton et al. (2012).

[9] EU Regulation 1060/2009.

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