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Do rating agencies cater? Evidence from rating-based contracts ☆

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ABSTRACT

I examine whether rating agencies cater to borrowers with rating-based performance-priced loan contracts (*PPrating* firms). I use data from Moody's Financial Metrics on its quantitative adjustments for off-balance-sheet debt and qualitative adjustments for soft factors. In the cross-section and for borrowers experiencing adverse economic shocks, I find that these adjustments are more favorable for *PPrating* firms than for other firms, consistent with rating agencies catering to the *PPrating* borrowers. I find that this catering is muted in two circumstances when rating agencies' reputational costs are higher than usual: (1) near the investment grade and prime short-term rating thresholds and (2) when Fitch Ratings also provides a rating.

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1. Introduction

Private loan agreements increasingly include performance-pricing provisions that raise loan interest rates or trigger early payment of principal when the borrowers' public credit ratings decrease (Beatty and Weber, 2003; Asquith et al., 2005), yielding direct and immediate adverse effects on the borrowers' cash flows (Nicholls, 2005). Rating agencies say that they are concerned about the potential adverse consequences of this contractual use of credit ratings for borrowers' creditworthiness (Moody's, 2001; Standard & Poor's, 2008). I test the 'catering hypothesis' that this concern causes rating agencies to cater to borrowers with these loans by providing credit ratings that are more favorable than the borrowers' credit risk justifies.[1] I further test whether reputational costs for rating agencies limit this rating inflation. Reputational costs might lead rating agencies to treat rating-based performance-pricing provisions in loan contracts as risk factors, due to the adverse effects on borrowers' cash flows when their credit ratings deteriorate.

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[1] Borrowers may try to influence their credit ratings for reasons other than existing performance-priced loans, such as achieving better valuations or gaining access to more liquid markets. These considerations are outside the scope of this paper.

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To identify catering, I examine rating agencies' hard and soft adjustments, which capture different dimensions of borrowers' credit risk. Hard adjustments capture credit risk arising from quantifiable factors such as off-balance-sheet debt (Moody's, 2006; Moody's, 2007; Kraft, 2014). Soft adjustments capture credit risk arising from qualitative factors such as management credibility. I infer catering when these adjustments are more favorable for borrowers with ratings-performance pricing (*PPrating* firms) than for borrowers with accounting-ratio based performance pricing (*PPratio* firms), all else being equal. In particular, because *PPratio* firms tend to be riskier than *PPrating* firms, I replicate all primary analyses partitioning the sample into groups of firms with homogeneous credit risk, and find the results are robust to this partition.

Using a sample of U.S.-domiciled, non-financial firms with information available on Moody's Financial Metrics and Dealscan for 2002 through 2008, I find that rating agency adjustments are more favorable for *PPrating* firms than for *PPratio* firms, consistent with the catering hypothesis. For example, the average adjustment for off-balance-sheet debt equals 14% of total assets for *PPrating* firms versus 21% for *PPratio* firms. Similarly, the average soft adjustment for *PPrating* firms is only a fifth of the soft adjustment for *PPratio* firms. Multivariate analysis confirms that the use of credit ratings rather than accounting ratios in performance pricing is associated with more favorable/less unfavorable estimates of off-balance-sheet debt and soft adjustments. I further find that *PPrating* firms that experience adverse economic shocks receive significantly less unfavorable rating agency adjustments than do *PPratio* firms receiving such shocks, again consistent with the catering hypothesis.

I find evidence that catering is muted in two cases where rating agencies likely bear heightened reputational costs from catering. First, I find no evidence that rating agencies cater to *PPrating* firms with ratings close to the critical investment-grade and prime short-term thresholds that act as gateways to lower priced and more liquid debt markets. Second, I find that rating agency adjustments are less favorable for *PPrating* firms with Fitch ratings, which unlike Moody's and Standard & Poor's ratings are not incorporated in *PPrating* contracts.

This paper contributes to several literatures. First, a sizeable literature examines whether rating agencies' business model of collecting fees from the issuers they rate creates a conflict of interest that leads to upwardly biased ratings in general (Partnoy, 1999; Beaver et al., 2006; Mason and Rosner, 2007; Cheng and Neamtiu, 2009; Becker and Milbourn, 2011; Bolton et al., 2012) and in particular for structured finance products (Mason and Rosner, 2007; Benmelech and Dlugosz, 2009). In the latter case, a debate exists as to whether rating inflation is due to catering or underestimation of the credit risk of these non-traditional products (Coval et al., 2009; Ashcraft et al., 2010; He et al., 2011; Griffin and Tang, 2012). This research has not empirically investigated the effect of debt contracts features, such as performance pricing, on catering, although Nicholls (2005) and Manso (2013) describes the feedback loop that result from the use of credit ratings in contracts. This study thus provides the first empirical evidence on the effect of the use of credit ratings in debt contracts on rating agencies' incentives in the rating process. My results are broadly consistent with the extensively studied debt covenant hypothesis, in that borrowers attempt to influence measures specified in debt contracts to achieve better outcomes under those contracts (Watts and Zimmerman, 1986; Beatty and Weber, 2003; Dichev and Skinner, 2002).

The study also contributes to the literature on the use of hard and soft information in contracting (Stein, 2002; Petersen, 2004; Rajan et al., 2010). Hard information is reliable and would evoke a consensus when presented to different parties; in contrast, soft information is generally not verifiable for contracting purposes (Rajan and Reichelstein, 2009). Consistent with Petersen (2004)'s conjecture, I show in this paper and in Kraft (2014) that while credit ratings primarily reflect quantitative information, they also reflect qualitative factors. These findings are broadly complementary to Ashbaugh-Skaife et al. (2006)'s finding that borrowers with better corporate governance receive more favorable credit ratings.

2. Hypothesis development

Ratings are benchmarks of issuers' credit worthiness. A large proportion of private debt contracts includes provisions that are based on issuers' public ratings, such as rating triggers and performance pricing. These provisions render debt contracts sensitive to rating changes. A rating trigger is a provision in a loan agreement that initiates a specific action in the event of a rating change. A rating downgrade might set off accelerated debt repayment or posting of collateral (SEC, 2003; Nicholls, 2005).[2] For a recent prominent example, the downgrade of AIG triggered some of its counterparties to demand additional collateral or principal repayments.[3] More generally, rating-based performance pricing refers to rating-sensitive debt obligations whose interest payments depend on the borrower's public ratings. Rating-based performance pricing provisions increase contractual interest rates when borrowers' ratings get downgraded and decrease contractual interest rates when borrowers' ratings get upgraded. Furthermore, parties to over-the-counter financial transactions explicitly or implicitly restrict themselves to dealing with counterparties with ratings above minimum levels (Moody's, 2001).

When contracts use credit ratings to enforce restrictions, changes in ratings directly and immediately impact firms' cash flows. This motivates the issuer to ask for favorable treatment by the rating agency. Under their business model, rating agencies collect fees from the very issuers they rate, which creates a basic conflict between providing accurate ratings and

[2] Nicholls (2005) lists default and acceleration triggers in loan agreements, pricing grids, security/collateral enhancement triggers, benchmark for triggering restrictive negative covenants, calculation of borrowing base and springing liens, and qualification of permitted assignees as rating triggers.

[3] See "AIG needs to address CDS portfolio to save ratings" by Reuters on February 27, 2009 and "AIG faces cash crisis as stock dives 61%" by The Wall Street Journal on September 16, 2009, as well as "Downgrades and Downfall. How could a single unit of AIG cause the giant company's near-ruin and become a fulcrum of the global financial crisis?" by Washington Post staff writers Robert O'Harrow and Brady Dennis on December 31, 2009.

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