



The impact of issuer-pay on corporate bond rating properties: Evidence from Moody's and S&P's initial adoptions[☆]



Samuel B. Bonsall IV

Fisher College of Business, The Ohio State University, 2100 Neil Avenue, Columbus, OH 43210, United States

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ABSTRACT

This study examines whether and how the properties of corporate bond ratings change following Moody's and S&P's adoptions of the issuer-pay business model in the early 1970s. Regulators and debt market observers have criticized the issuer-pay model for creating an independence problem. However, the issuer-pay model allows for economic bonding between rating agencies and issuers through explicit contractual arrangements, which should improve the flow of nonpublic information. Using a difference-in-difference research design, I find that more optimistic ratings by issuer-pay rating agencies predict greater future profitability, differences between the ratings of issuer-pay and investor-pay rating agencies are associated with narrower secondary bond market bid-ask spreads, and that issuer-pay rating agencies become relatively more accurate and timely predictors of default compared to investor-pay agencies after the adoption of issuer-pay. These results reinterpret the recent findings of optimistic ratings by [Jiang et al. \(2012\)](#) as consistent with more informative bond ratings.

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1. Introduction

Bond rating agencies play a critical role in intermediating bond markets by providing information to prospective investors about the default risk of bond issues. A popular concern regarding the ratings' process is that the bond issuer generally pays the rating agency, which potentially compromises the information content of the rating by creating an independence problem.¹ In fact, legislators' concerns are significant enough that the Dodd–Frank Act of 2010 has required the Securities and Exchange Commission (SEC) to study rating agency revenue models. Although the relation between the

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¹ See [Coffee \(2008\)](#), [Egan \(2008\)](#), [Gellert \(2009\)](#), [Securities and Exchange Commission \(2003\)](#), and [Partnoy \(1999, 2001, 2006\)](#) for various allegations of underperformance by the rating agencies as a result of receiving fees from debt security issuers.

rating agency and the firm whose bond is being rated creates a potential independence problem, rating agencies' desires to maintain their reputations in the marketplace could mitigate that problem.² Furthermore, the business relation itself may allow the rating agency to obtain additional information about issuers' prospects because of reduced disclosure costs faced by issuers, which would potentially increase the information content of the rating.³ Thus, it is unclear how the rating agency's revenue model influences the information content of a bond rating. In order to assess how issuer-pay influences the information content of ratings, I examine whether the adoption of the issuer-pay revenue model (issuer-pay) by major rating agencies leads to systematic changes in the information conveyed by their ratings.⁴

Using a difference-in-difference (DID) research design, I find that differences between the corporate bond ratings of test and control rating agencies are more strongly associated with issuers' future profitability and secondary bond market bid-ask spreads and that test rating agencies become relatively more accurate and timely predictors of default compared to control agencies after the adoption of issuer-pay. These primary results are somewhat weaker for the ratings of issuers that generate presumably the most fee revenue for issuer-pay rating agencies, consistent with catering incentives reducing overall issuer-pay rating improvements, and stronger for ratings of issuers with poorer information environments. The poor information environment results suggest that in the cross-section of issuers with the least robust public information, increased access to nonpublic information improves the issuer-pay rating agencies' ratings the most. In a recent study, [Jiang et al. \(2012\)](#) find evidence that Moody's Investors Service (Moody's) provided more optimistic ratings than Standard & Poor's (S&P) prior to S&P's adoption of issuer-pay in 1974 but not follow S&P's adoption. Overall, this study's results reinterpret the recent findings of optimistic ratings by [Jiang et al. \(2012\)](#) as consistent with more informative bond ratings. While the findings of [Jiang et al. \(2012\)](#) are somewhat indicative of bias in bond ratings following the adoption of issuer-pay, my results suggest that seemingly more optimistic ratings are associated with stronger future financial performance, contrary to expectations under the assumption of bias.

Following [Jiang et al. \(2012\)](#), I take advantage of a quasi-experiment—the initial adoption of issuer-pay by Moody's and S&P in the 1970s—to test whether the information content of bond ratings worsened or improved under issuer-pay relative to investor-pay in a DID research design. This setting allows me to hold constant other potential drivers of bond rating quality, such as the provision of consulting services, and focus only on how *charging issuers* for bond ratings affects ratings' informativeness. Furthermore, I can compare each rating agency to the other as a control group. As initially described by [Jiang et al. \(2012\)](#), on October 1, 1970 Moody's became the first major rating agency to charge corporate issuers after many decades of earning revenue from the sale of its research to investors through its *Moody's Industrial Manuals*. S&P delayed changing to issuer-pay until July 1, 1974, after also originally using an investor-pay model.

The adoption of issuer-pay could, as critics suggest, create incentives for the major rating agencies to become more aligned with their clients. This could lead rating agencies to only communicate information that benefits their clients, resulting in less informative ratings under issuer-pay than investor-pay. However, as discussed by [Cantor and Packer \(1994\)](#) and [Covitz and Harrison \(2003\)](#), the possibility for reduced communication is tempered by potential reputational consequences.

Alternatively, the adoption of issuer-pay could lead to more informative ratings because the major rating agencies would gain greater access to private information *and* better resources. First, issuers face a potentially greater incentive to disclose their private information to rating agencies following issuer-pay adoption. Issuers, naturally motivated to lower their cost of debt by fully disclosing their private information to potential investors, typically limit their disclosure because of costs (e.g., proprietary, litigation). They could, however, safely provide detailed private information to rating agencies in their role as information intermediaries because disclosed information is only partially conveyed through credit ratings ([Griffin and Sanvicente, 1982](#); [Kliger and Sarig, 2000](#); [Tang, 2009](#); [Walker, 2010](#)) and issuers can better legally protect confidential information disclosed to a rating agency receiving compensation for its services based on trade secret law ([Saulino, 2002](#)).⁵ Under issuer-pay, the fiduciary responsibility of rating agencies toward the issuer to not reveal the issuer's private information is potentially greater because of the explicit contractual relationship between the issuer and the rating agency and its accompanying economic consideration to maintain confidentiality ([Bast, 1999](#); [Whaley, 1998](#)).⁶ In this sense, issuer-pay should promote the sharing of value-relevant information with rating agencies.

² Various studies have noted the importance of reputation to bond rating agencies including [Cantor and Packer \(1994\)](#), [Smith and Walter \(2002\)](#), [Covitz and Harrison \(2003\)](#), and [Securities and Exchange Commission \(2003\)](#).

³ Several academic studies have conjectured that rating agencies may benefit from the sharing of private information from bond issuers ([Griffin and Sanvicente, 1982](#); [Kliger and Sarig, 2000](#)). Furthermore, the rating agencies themselves and industry observers have asserted that the move to the issuer-pay model led to greater access to information ([McDaniel, 2009](#); [Walker, 2010](#)). I test these conjectures directly.

⁴ Bond rating agencies are not the only information intermediaries that face a potential independence problem. Audit firms receive fees in exchange for an opinion as to whether a company's financial statements conform with generally accepted accounting principles (GAAPs). In addition, equity analysts whose firms provide investment banking services also face the so-called independence problem when offering stock recommendations and earning forecasts about investment banking clients. Finally, the Better Business Bureau's reliability ratings, the American Automobile Association's diamond ratings for hospitality providers, and Underwriters Laboratory's certifications of product quality and safety all rely on fees paid by the company seeking the rating.

⁵ Several empirical studies suggest that bond ratings do contain private information ([Butler and Cornaggia, 2012](#); [Gan, 2004](#); [Jorion et al., 2005](#)). However, as noted by [Griffin and Sanvicente \(1982\)](#), it is difficult to conclude unambiguously that information produced by the rating agencies per se drives equity market reactions to rating changes rather than information correlated with the rating process. [Tang \(2009\)](#), however, finds that following Moody's refinement of its rating scale, firms that received higher (lower) refined ratings experience a decrease (increase) in their bond yield spreads.

⁶ In fact, *issuer-pay* but not *investor-pay* rating agencies frequently sign confidentiality agreements with their issuer clients to cover all shared material nonpublic information ([Langohr and Langohr, 2008](#)).

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