



Are unsolicited ratings biased? Evidence from long-run stock performance



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ABSTRACT

We test the biasedness of unsolicited ratings relative to solicited ratings using the *ex post* firm performance measured by the long-run stock performance of firms following rating announcements and changes. We find that the announcements of new unsolicited ratings are followed by negative long-run stock performance, while those of new solicited ratings are followed by insignificant long-run stock performance. These results are inconsistent with the conservatism hypothesis that suggests that unsolicited ratings are downward biased. We further demonstrate that firms with solicited upgraded (downgraded) ratings experience subsequent positive (negative) abnormal stock performance, while those with unsolicited rating changes have zero abnormal stock performance. The differential stock performance following rating changes between solicited and unsolicited ratings reflect the differential information carried by each type of rating rather than the biasedness in ratings. Specifically, while solicited ratings are based on both public and private information, unsolicited ratings are mainly based on public information. Overall, we find no evidence for a downward bias in unsolicited ratings.

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1. Introduction

S&P's and Moody's—the “Big Two” rating agencies—issue two types of credit ratings: solicited and unsolicited. For solicited ratings, borrowers request ratings, provide private information, and pay the rating agencies. In contrast, the rating agencies assign unsolicited ratings to public companies with only publicly available information and without the request of the debt issuers. Moody's (2006) claims that it publishes unsolicited ratings to protect investors from rating shopping.¹ Previous studies document that unsolicited ratings tend to be lower than solicited ratings.² Whether lower unsolicited ratings relative to solicited ratings reflect the biasedness of unsolicited ratings remains controversial. In this paper, we examine the long-run stock performance of firms with solicited

and unsolicited ratings to empirically evaluate existing explanations for lower unsolicited ratings relative to solicited ratings.

Bannier et al. (2010) suggest that self-selection causes high-quality companies to solicit ratings and low-quality firms to avoid soliciting ratings. According to the “self-selection hypothesis,” unsolicited ratings are not downward biased. Rather, they reflect the lower quality of firms that do not solicit ratings. Fulghieri et al. (2014) develop a model demonstrating that lower unsolicited ratings are not the result of biasedness; rather, they are the result of a lower quality of issuers. Bannier et al. (2010) also suggest an alternative explanation: i.e., rating agencies issue lower unsolicited ratings because rating agencies are strategically conservative in order to avoid overrating the issuer. Poon (2003), Van Roy (2013), and Poon et al. (2009), on the other hand, suggest that rating agencies either provide misleading information or fail to disclose other important facts when issuing unsolicited ratings as a punishment for issuers that do not pay for rating services. Under the “conservatism/punishment hypothesis,” lower unsolicited ratings reflect a downward bias toward these issuers.

The prior literature has employed several measures to test these hypotheses and some conflicts may result from the choice of performance measure. For example, Gan (2004) and Bannier et al. (2010) provide supporting evidence for the self-selection

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¹ Rating shopping occurs when issuers shop among various rating agencies for the highest ratings in order to reduce the cost of debt.

² For example, see Poon (2003), Van Roy (2013), Shimoda and Kawai (2007), Behr and Güttler (2008), Poon et al. (2009), Bannier et al. (2010), and Byoun and Shin (2012).

hypothesis as well as weak evidence for the conservatism hypothesis from an *ex post* measure, i.e., the default realization. In contrast, most other empirical studies (as described later in the literature review), rely on *ex ante* measures—such as the default risk prediction based on firm characteristics—and document a downward bias for unsolicited ratings. As [Bannier et al. \(2010\)](#) point out, however, the *ex ante* measures fail to account for firm characteristics that may be hidden *ex ante*, yet materialize *ex post*. [Fulghieri et al. \(2014\)](#) also suggest that the biasedness of ratings is reflected in the *ex post* performance of rated firms. We use long-run abnormal stock performance as an *ex post* measure of firm performance, which we believe should reflect the biasedness of information in the ratings.

According to the self-selection hypothesis, unsolicited ratings are as good as solicited ratings in predicting the *ex post* performance of rated firms. This implies that there is no difference in the abnormal long-run stock performance between firms with solicited and unsolicited ratings. In contrast, the conservatism hypothesis would predict that the abnormal long-run stock performance following unsolicited ratings is greater than the performance following solicited ratings because unsolicited ratings are downward biased.

We further analyze the information content of the ratings by examining the abnormal long-run stock performance following solicited and unsolicited rating changes. Rating changes, whether solicited or not, should be driven by new information affecting issuers' credit risks. Accordingly, the abnormal long-run stock performance following solicited and unsolicited rating changes provides an interesting setting in which we further test whether unsolicited rating changes are biased or not. If unsolicited rating changes are downward biased—e.g., the rating agency downgrades unsolicited ratings even further in order to increase pressure on firms to solicit a rating—then unsolicited rating changes would precede better abnormal long-run stock performance. Whereas solicited rating changes reflect both private and public information stemming from the ongoing interaction between the rating agency and the issuer, unsolicited rating changes are most likely initiated by public information only. Consequently, even in the absence of biasedness, unsolicited rating changes are not likely to convey information as much as solicited rating changes.

We start by examining 233 announcements of unsolicited ratings in Japan and later include 307 announcements in other countries by S&P's during the 1996–2003 period when S&P's publicly differentiates between solicited and unsolicited ratings. We separate Japanese firms from other nations' firms because unsolicited ratings are most prevalent among Japanese firms and the Japanese stock market is relatively frictionless. Long-run stock performance is measured for up to two years in two ways: buy-and-hold abnormal returns (BHARs) and calendar-time portfolio alphas. For Japanese firms, we find that new unsolicited ratings are followed by negative abnormal long-run stock performance, which is significantly lower than the abnormal long-run stock performance followed by solicited ratings. When we separate the sample into investment and speculative grades, we find that the difference in firm performance between solicited and unsolicited ratings becomes much weaker. For other countries, we also find lower long-run stock performance following unsolicited ratings relative to that following solicited ratings, but the difference is not significant. Thus, our findings from the abnormal long-run stock performance following new ratings are consistent with the self-selection hypothesis.

Solicited upgrades for Japanese firms are followed by positive abnormal long-run stock performance, whereas unsolicited upgrades are followed by insignificant abnormal long-run stock performance. Likewise, firms with solicited downgrades experience negative abnormal long-run stock performance, while firms with

unsolicited downgrades do not experience significant abnormal long-run stock performance. For non-Japanese firms, we also find that unsolicited downgrades are followed by insignificant abnormal long-run stock performance. These results are robust to the length of the holding period. It appears that unsolicited rating changes do not carry any incremental information for issuers' long-run performance. Given that unsolicited rating changes are based on information in the public domain, we take this finding as evidence for the unbiasedness of unsolicited rating changes.

We conduct additional robustness tests. First, we calculate the abnormal returns for a sub-sample of Japanese firms that initially have unsolicited ratings, then subsequently this “unsolicited” rating status is effectively hidden due to the change in S&P's policy.³ This sub-group usually experiences positive event month returns, suggesting that the stock market may view this as a positive event. Long-run returns, however, are mostly negative or insignificant, similar to those reported with the full sample. We also check if the performance following rating changes is over- or under-stated because of credit watch announcements during the measurement period. We do not report the results for brevity, but credit watches are relatively rare and their effects do not have material impacts on our results. Finally, we utilize all available global firms to test the biasedness of unsolicited ratings. Data limitations in constructing reliable abnormal long-run stock performance measures (stemming from the very small number of observations in each country) prevent us from drawing strong conclusions. Yet, the overall results are consistent with the self-selection hypothesis.

Our study makes several contributions to the existing literature on credit ratings by examining the long-run stock performance of non-US firms that receive solicited and unsolicited new ratings and rating changes. First, our study is the first to investigate long-run stock performance following the announcements of unsolicited credit ratings and their changes for non-US firms. [Dichev and Piotroski \(2001\)](#) and [Liu and Sun \(2011\)](#) examine the long-run stock performance of US firms following bond rating changes by Moody's, but their investigation is limited specifically to solicited ratings. Moreover, our interest is not the stock performance *per se*, yet we use it as the *ex post* measure of firm performance in order to test the theories on the biasedness of unsolicited ratings. Second, our study examines the *ex post* differential firm performance of firms with solicited and unsolicited credit ratings. [Gan \(2004\)](#) and [Bannier et al. \(2010\)](#) provide direct evidence from the *ex post* default realization of solicited and unsolicited ratings. Unlike defaults that may represent only a limited number of extreme observations reaching a threshold point in a firm performance scale, our firm performance measures can be applied to all firms even before firms reach the default state. Finally, our study is also the first to show the differential *ex post* effects of solicited and unsolicited rating changes. Previous studies mainly focus on new ratings, but not on rating changes.

In contrast to the prediction of the conservatism hypothesis, new unsolicited ratings are associated with lower or insignificantly different *ex post* firm performance compared to similar solicited ratings, which suggests that unsolicited ratings are not downward biased. The negative abnormal stock performance following new unsolicited ratings may indicate the limitation of agencies in processing only public information about “bad” firms because these bad firms will not solicit ratings only when their “badness” is not fully revealed by unsolicited ratings. Given that the differences in firm performance between solicited and unsolicited ratings are

³ S&P removed the “pi” subscript from rating symbols for 107 Japanese firms on October 21, 2003. Instead, they began assigning “Outlooks” and “CreditWatch” on the ratings of those firms. As a result, those firms without the “pi” subscript have identical ratings before and after the policy change. (S&P's CreditWeek, “Ratings Services Expanded in Japan,” October 29, 2003, pp. 10–11).

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