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Foreign ownership and the credibility of national rating agencies: Evidence from Korea

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ABSTRACT

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By analyzing bond price reactions to rating changes in Korea, this study adds a new angle to the existing literature on Global Rating Agencies (GRAs, i.e. Moody's, S&P's, Fitch) with higher reputation/independence vs. National Rating Agencies (NRAs) with more in-depth local knowledge. Faced with substantial regulatory burdens, GRAs have chosen to operate indirectly in the Korean domestic market by acquiring local NRAs. In our event study, cumulative abnormal returns following downgrades by a wholly domestically owned NRA tend to dominate those from downgrades by two affiliates of GRAs. This casts doubt on the additional information value of reputation capital acquired through GRA ownership as perceived by emerging markets. *Journal of Comparative Economics* **41** (3) (2013) 762–776. Department of Economic, Political Sciences and of Modern Languages, LUMSA, Via Pompeo Magno, 22, 00192 Rome, Italy; Department of Economics and Mathematics, University of Bari Aldo Moro, Via C. Rosalba, 53, 70124 Bari, Italy; Graduate School of International Studies, Yonsei University, 50 Yonsei-ro, Seodaemun-gu, Seoul 120-749, Republic of Korea.
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1. Introduction

The literature on credit rating agencies highlights a potential trade-off between the higher reputation and independence of the Global Rating Agencies (GRAs) with worldwide operations (Partnoy, 1999; White, 2002, 2010) and the in-depth knowledge of National Rating Agencies (NRAs) with a specific local focus. GRAs mainly include Moody's, Standard & Poor's (S&P's), and Fitch, whereas NRAs are mostly located in Asia. Some authors suggest a possible complementarity between GRAs and NRAs, reflected in the pattern of specialization where NRAs concentrate on rating smaller-sized/domestic-focused companies while GRAs devote themselves to rating larger/more internationalized companies (Ferri et al., 2006; Ferri and Lacitignola, 2010).

Since reputation capital works as an asset (good will), financial markets may regard the rating agencies with higher reputation capital as more reliable. Through their extensive presence in the financial markets, GRAs have gained and hence hold

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high reputation capital consolidated over time. In contrast, the reputation capital of NRAs with a much shorter history has to be relatively limited, as much as it takes a long time to build reputation. To the extent that the information value of reputation capital outweighs that of in-depth local knowledge, GRAs' rating changes should have a more pronounced effect on the financial markets.

To determine whether the greater reputation capital of GRAs provides a higher information value, one can examine how financial markets react to rating changes by the two groups of rating agencies. The actual testing of this sort, however, is somewhat complicated due to fact that only few financial markets have experienced the coexistence of both GRAs and NRAs for an extended period. As Bank for International Settlements (2000) points out, the last couple of decades have seen a sharp increase in the number of NRAs to be established, but only a few of them have managed to survive to issue a sizable sum of ratings.

In this respect, Korea provides a unique experiment opportunity. Due to regulatory burdens, GRAs choose not to establish their subsidiaries or branches directly in the domestic Korean market. Thus, it is not possible in the strict sense to compare Korean NRAs with GRAs in respect to market reactions to their rating changes. Nevertheless, while one of the three longer established Korean NRAs has wholly Korean ownership, the other two have been affiliated to GRAs such as Moody's and Fitch since 2001, likely benefiting from credibility of their mother GRAs. Therefore, the value of reputation capital embedded in the GRA affiliation, if any, is likely to be reflected in the gap in market reactions to rating changes between the wholly Korean owned agency and the affiliates of GRAs.

We consider all ratings changes, referring to domestic Korean corporate bond issues, enacted between 2001 and 2007, so to avoid any confounding effect deriving from the global financial crisis of 2008–2009. On this database, we run an event study to compute the cumulated abnormal returns – calculated on the respective bond prices – following rating changes. Consistently with the literature, the impact of upgrades is found to be generally insignificant; thus, we focus on downgrades. The results of the event study highlight that in most cases the two GRA affiliates are dominated by the only independent, Korean owned, NRA. Therefore, our results cast some doubts on the additional information value of reputation capital acquired through GRA ownership as perceived by emerging markets.

In the remainder of the paper, Section 2 portrays a review of the relevant literature on credit rating agencies, with a specific focus on the studies contrasting GRAs and NRAs. In Section 3 we describe the specificity of the Korean case and the basic statistics of the rating changes compiled in our database. Section 4 presents the methodology of our event study and reports the main results as well as the related comments. In Section 5 we recap the paper and briefly discuss the implications of our findings.

2. Review of the literature: global rating agencies vs. national rating agencies

Credit rating agencies (CRAs) issue opinions on the creditworthiness of both financial and non-financial entities and on the financial instruments (such as bonds, stocks and structured finance products) issued by those entities. Ratings are an important ingredient of financial markets as they help "to pierce the fog" of informational asymmetries (White, 2002).

Most issuers need to obtain a rating from at least one rating agency to gain access to financial markets. The importance of credit ratings has grown in the last couple of decades as financial markets transactions have expanded sharply (see, among others, Cantor and Packer, 1994; Sinclair, 2003; Fabozzi, 2001; SEC, 2003). Furthermore, rating agencies have been assuming an increasingly wider role in global capital markets due to: (1) the growth in the number of companies issuing securities; (2) the development of innovative financial products such as asset-backed securities and credit derivatives; (3) the globalization of financial markets; and (4) the increasing use of credit ratings in financial regulation.[3]

Furthermore ratings are used at a national as well as international level to regulate the investment behavior of financial institutions and investors. An example of their use at the national level includes the requirement for U.S. financial institutions to comply with the SEC's Net Capital Rule (Rule 2a-7).[4] At the international level, ratings are used to determine the minimum capital requirements of banks under the Basel II Agreement.

Despite its importance, the rating industry is characterized by the small number of its players (White, 2002, 2010). The dominant players are US-based; they are Moody's and S&P's, followed by Fitch at a distance. Their activity began in the early 1900s and spans almost all over the world through foreign affiliates such as their own branches as well as subsidiaries or associates. Since Moody's, S&P's and Fitch rate issuers and financial instruments on a global basis through their foreign affiliates, they are labeled GRAs.

Largely due to the reputation and regulatory mechanism (Partnoy, 2006), the two major GRAs (Moody's and S&P's) have reinforced their market positions in the industry whose worldwide market structure is in fact close to a near-duopoly. Kish et al. (1999) examine the impact of credit ratings issued by Moody's and S&P's on yields of 1,607 U.S. industrial bonds over the period 1986–1996. They find no evidence of a stronger information content of Moody's ratings with respect to S&P's

[3] Among others, see the U.S. Securities and Exchange Commission (SEC) (2003a), Bank for International Settlements (BIS) (2004), Gonzales et al. (2004), and International Monetary Fund (IMF) (1999).

[4] The Net Capital Rule requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value of their proprietary security positions; also Rule 2a-7 under the 1940 Investment Company Act limits money market funds to investing only in high quality short term instruments.

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