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Opportunistic behaviors of credit rating agencies and bond issuers

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ABSTRACT

Using credit rating data from the three credit rating agencies (CRAs) in Korea, we examine whether bond issuers and CRAs engage in rating shopping and catering. First, we find that Korean bond issuers, who are required by law to receive two or more ratings, tend to fire or switch from CRAs that assign lower ratings than other CRAs. Second, when a bond issuer hires an additional CRA, the new CRA assigns a higher rating than incumbent CRAs. Lastly, we see that increased competition, which is measured by the number of CRAs hired by a given bond issuer, affects the likelihood of an upgrade occurring. Although CRAs often upgrade ratings when their rivals assign higher ratings, our findings show that higher competition further increases the likelihood that CRAs will upgrade ratings when there are rating disagreements. These results imply that bond issuers and CRAs engage in opportunistic behaviors that undermine the quality of credit ratings.

1. Introduction

Credit rating information helps creditors make lending decisions by reducing information asymmetry about debtors' ability to pay back (Camanho et al., 2012; White, 2010). However, information users may not be able to make effective decisions if the information is not reliable (Akerlof, 1970). When this happens, some potential creditors may give up on a lending decision or increase risk premiums due to the adverse selection problem. In the lending process, credit rating agencies (CRAs, hereafter) play a key role in monitoring bond issuers by providing high-quality credit rating information. Bond issuers and CRAs, however, have incentives to engage in opportunistic behaviors that undermine rating quality. Bond issuers want to obtain higher ratings, as credit ratings have significant influences not only on the cost of debt but also on capital structures and stock prices (Hand et al., 1992; Kisgen, 2006; Tang, 2009; Kraft, 2015). Given that bond issuers prefer higher ratings, CRAs may want to maintain their business or increase their market share by giving favorable ratings to bond issuers, who pay rating fees (Skreta and Veldkamp, 2009; Mathis et al., 2009; Bar-Isaac and Shapiro, 2013; Bolton et al., 2012; Griffin et al., 2013).

Although several researchers have studied rating shopping and catering, it is worth investigating opportunistic behaviors using Korean credit rating data because the Korean market provides a unique environment different from that of other countries. In Korea, bond issuers are required by law to acquire two or more ratings for their corporate bonds.³ This requirement provides researchers

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³ Article 4-63 of the Regulation on Financial Investment Business in Korea prohibits issuing unsecured corporate bonds that have not been assessed by two or more credit rating agencies. Thus, bond issuers in Korea must choose at least two CRAs among the following three possible CRAs: the Korea Investors Service, Inc., NICE Investors Service, Co., and Korea Ratings, Inc.

with a sufficient number of observations to compare ratings and prevents the self-selection problem when multiple ratings are not required.⁴ Just as studies of auditor switching show that companies change auditors for opinion shopping (Chow and Rice, 1982; Simon and Francis, 1988; Krishnan, 1994; Krishnan and Stephens, 1995; Lennox, 2002), we demonstrate that bond issuers fire CRAs that give lower ratings than other CRAs for rating shopping. Conversely, CRAs are less likely to be fired when they give better ratings than other CRAs.

This firing behavior may result in competition in the credit rating market, inducing CRAs to cater to their clients to increase the market share or maintain business. For instance, when a bond issuer hires an additional CRA, the issuer may put pressure on the new CRA to give higher ratings than those given by the incumbent CRAs. Alternatively, if the new CRA wants to increase the market share, the CRA may initiate contracts and provide higher ratings to attract clients. We therefore also investigate whether new CRAs cater to bond issuers. Our results show that new CRAs assign higher ratings than incumbent CRAs. Lastly, we show that increased competition, which is measured by the number of CRAs hired by a given bond issuer at, affects the likelihood of an upgrade occurring. Consistent with the results of studies on the convergence of credit ratings (Güttler, 2011; Lugo et al., 2015), we find that a CRA is likely to upgrade a rating when its rival is giving a higher rating; conversely, the CRA is less likely to upgrade the rating in the opposite case. Our findings show that higher competition further increases the likelihood of an upgrade when a CRA assigns a lower rating than its rivals. Moreover, the effect of competition persists even when CRAs assign higher ratings than their rivals. These findings are consistent with those of Becker and Milbourn (2011), Camanho et al. (2012), and Griffin et al. (2013).

This paper offers several contributions. First, we provide additional evidence of rating shopping in the form of firing or replacement, as observed in the Korean credit market. To the best of our knowledge, no study has investigated whether bond issuers fire or replace their incumbent CRAs selectively for rating shopping purposes. Second, this paper elucidates the specific circumstances in which CRAs cater to bond issuers: bond issuers hire an additional CRA and the number of rivals increases. Unlike the mixed findings in prior studies using the market share of Fitch as a proxy for market competition (Becker and Milbourn, 2011 and Bae et al., 2015), we use a direct proxy for increased competition measured by the number of CRAs that evaluate a given bond issuer. Third, we provide an additional finding to complement the rating convergence literature. When competitive pressure is high, CRAs are likely to upgrade ratings not only when they assign a lower rating, but also when they assign a higher rating than their rivals. Lastly, this paper provides useful information to regulators and investors, as it shows specific circumstances under which bond issuers and CRAs are likely to engage in opportunistic behaviors.⁵

2. Literature review and hypothesis development

2.1. Literature review

Researchers have conducted studies on rating shopping and rating catering. Klein and Leffler (1984) provide a theoretical statement that sellers lack the incentive to provide high-quality products when customers do not know their quality before they buy them. However, as the sellers and customers gain experience with each other, customers begin to recognize the quality of the product from previous purchases. Klein and Leffler (1984) conclude that sellers maintain a good reputation by supplying high-quality products to guarantee future income. Most studies on rating inflation develop their logic based on this theory. They find equilibrium between obtaining short-term benefits by inflating ratings and enjoying long-term benefits by maintaining reputation.

Mathis et al. (2009) argue that CRAs are more likely to give favorable ratings to clients with complex bond structures because it is difficult for investors to detect such opportunistic behaviors. Bar-Isaac and Shapiro (2013) show that rating accuracy decreases when a business cycle is in a good state because the probability of a bond defaulting decreases and because of the difficulty of retaining and hiring analysts. Camanho et al. (2012) maintain that CRAs pursue short-term income from rating inflation rather than long-term revenue from maintaining reputation, especially when they experience competitive pressure. Bolton et al. (2012) also show that the reputation incentive fails when there is keen competition and when investors tend to trust ratings. Sangiorgi and Spatt (2016) explain that rating inflation occurs when investors do not know whether a bond issuer received a rating from a credit rating agency. Under these conditions of opacity, the issuer can choose not to publish poor ratings, choosing instead to disclose only satisfactory ratings. Skreta and Veldkamp (2009) find that the complexity of issuers' assets affects the tendency toward rating shopping. For issuers with simple assets structures, the variation of ratings given by CRAs is small. In this case, the issuer has little chance to buy a favorable

⁴ In circumstances where double ratings are not required, companies engage in rating shopping, choosing the highest rating among multiple ratings. As this paper requires companies to have at least two ratings for comparison purposes, issuers that receive only one rating are not included in the sample. This is problematic because companies engaging in rating shopping would obviously hire the CRA that gives the best rating (Benmelech and Dlugosz, 2010). In such cases, issuers that self-select to receive multiple ratings are less likely to fire a CRA for rating shopping. Therefore, the norm of double ratings solves the self-selection problem, as companies engaging in rating shopping must, by law, receive two ratings; these have been included in the sample. Although U.S. companies are not required to receive two or more credit ratings, according to Mählmann (2009), most U.S. companies receive double ratings from Moody's and S&P. Because the double rating is a norm in the U.S. as well, U.S. companies engaging in rating shopping may also decide to receive double ratings because deviation from the norm would be noticed by investors. In such cases, the self-selection problem mentioned above may be minimal. However, issues related to switching and firing do not occur in the U.S. because U.S. companies usually choose to receive a third rating from Fitch in addition to the double ratings from Moody's and S&P. They are not likely to replace S&P with Fitch or other CRAs, although Fitch also has a substantial market share, which ranges from 10.9 to 25% across rating categories as of 2015 according to the SEC (2016). Therefore, the Korean rating market provides an appropriate environment to investigate the firing and replacing behaviors of bond issuers.

⁵ The Financial Supervisory Service, which corresponds to the U.S. Securities and Exchange Commission (SEC), released a plan for the advancement of the credit rating market on September 21, 2016. The plan requires that the Korea Financial Investment Association (KFIA) disclose detailed information on the performance of CRAs, which includes default rates, rating trends of bankrupt companies, and the names of companies that experience rapid changes in ratings.

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