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# Can investor-paid credit rating agencies improve the information quality of issuer-paid rating agencies? ☆

Han Xia\*

Naveen Jindal School of Management, The University of Texas at Dallas, 800 West Campbell Road SM 31, Richardson, TX 75080, USA

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## ABSTRACT

This paper examines how the information quality of ratings from an issuer-paid rating agency (Standard and Poor's) responds to the entry of an investor-paid rating agency, the Egan-Jones Rating Company (EJR). By comparing S&P's ratings quality before and after EJR initiates coverage of each firm, I find a significant improvement in S&P's ratings quality following EJR's coverage initiation. S&P's ratings become more responsive to credit risk and its rating changes incorporate higher information content. These results differ from the existing literature documenting a deterioration in the incumbents' ratings quality following the entry of a third issuer-paid agency. I further show that the issuer-paid agency seems to improve the ratings quality because EJR's coverage has elevated its reputational concerns.

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## 1. Introduction

Credit rating agencies face growing criticism and regulatory pressure for their inability to adequately predict firm defaults. It is widely acknowledged that the ratings provided by major rating agencies (e.g., Standard and Poor's (S&P), Moody's, and Fitch) lack timeliness and are unresponsive to market-based risk measures.<sup>1</sup> Since the early 2000s, the low quality of ratings has been attributed to the monopolistic conditions in the rating industry that is largely dominated by S&P and Moody's (Association for Financial Professionals, 2002). However, in a recent study by Becker and Milbourn (2011), the authors find that the

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\* Tel: +1 972 883 6385; fax: +1 972 883 2799.

E-mail address: [Han.Xia@utdallas.edu](mailto:Han.Xia@utdallas.edu)

<sup>1</sup> The survey by Baker and Mansi (2002) reports that only 29% of bond fund managers believe the Nationally Recognized Statistical Rating Organization (NRSRO) updates their ratings in a timely and accurate manner. Similarly, a survey conducted by the Association for Financial Professionals (AFP, 2002) reveals that a quarter of respondents believed that their companies' ratings were not accurate and approximately 60% of practitioners observed a lack of timeliness in rating changes.

major entry of Fitch, a third issuer-paid rating agency, is followed by even less informative and more issuer-friendly ratings from the incumbents. This finding highlights a potential downside of an issuer-paid entrant that can aggravate existing agencies' incentives to compromise ratings quality and please their customers.

In this paper I study how the ratings quality of issuer-paid incumbents responds to the entry of a different type of rating agency compensated by investors. Investor-paid rating agencies have generated growing attention amid the market's criticism of issuer-paid raters. [Beaver, Shakespeare, and Soliman \(2006\)](#) compare different ratings properties between Moody's and Egan-Jones Rating Company (EJR), an independent, investor-paid agency, and find that EJR produces more informative ratings than Moody's. In a similar vein, [Cornaggia and Cornaggia \(2013\)](#) document that while issuer-paid agencies tend to cater to issuers' interests and understate credit risk, Rapid Ratings, another subscriber-paid rater, provides more timely ratings that are aligned with investors' demands. This set of evidence points to a notable distinction between the issuer-paid and investor-paid agencies as incoming raters into the rating industry. As shown in [Bongaerts, Cremers, and Goetzman \(2012\)](#), the entering issuer-paid agency, Fitch, primarily serves as a marginal rater to boost an issuer's overall rating profile without providing additional information related to credit quality.<sup>2</sup> Fitch's entry therefore raises explicit competition to the issuer-paid incumbents and pressures them into catering to issuers' demands via inflated and less informative ratings. On the contrary, investor-paid agencies enter the market to deliver more timely and informative ratings that can potentially reveal the low quality of the incumbents' existing ratings. This different type of entrant can thereby result in a distinct effect on the incumbent agencies' incentives and quality provisions.

I study this implication using S&P and EJR as representatives of the two types of rating agencies. In comparing the information quality of S&P's ratings before and after EJR's coverage initiation of each given firm, I find a significant improvement in S&P's ratings quality following EJR's coverage. S&P's ratings become almost three times more responsive to changes in credit risk as measured by the expected default probability derived from the [Merton \(1974\)/KMV](#) framework. S&P's rating changes incorporate higher information content and trigger market reactions that are 50% stronger than those before EJR's coverage. In addition, S&P seems to adopt more stringent standards and becomes more conservative in assigning ratings. These results differ from the existing literature that shows a deterioration in the incumbents' ratings quality and more inflated ratings following Fitch's material entry.

My empirical approach relies on EJR's coverage initiation as the inception of EJR's impact on S&P's rating strategies. In practice, EJR initiates coverage of a firm based on subscribers' (investors') requests. As a result, EJR's coverage might

not be exogenously determined; investors might have requested EJR's coverage when they are concerned with a firm's uncertain credit risk, or with the unresponsiveness of S&P's ratings in capturing such risk. If investors' concerns can simultaneously lead S&P to adjust its ratings quality regardless of EJR's coverage, the effect of EJR's coverage on S&P's rating strategies will be overestimated.

I employ three complementary approaches to remedy this issue. First, I use an instrumental variables analysis to establish a causal role of EJR's coverage. The instrument for the timing of EJR's coverage on each firm is the firm's concurrent industry-average market capitalization. This instrument can predict EJR's coverage decisions because EJR follows the policy of initiating firm coverage at the request of its subscribers provided that the firm is a large-capitalization firm. On the other hand, the industry-level market capitalization is unlikely to be directly correlated with S&P's ratings quality for a particular firm.<sup>3</sup> Using this instrumental variables procedure, the effect of EJR's coverage on S&P's ratings quality becomes even larger in magnitude than that estimated in the ordinary least squares (OLS). This indicates that EJR initiates coverage of a firm whose S&P ratings would otherwise have been even less informative had EJR not covered it, confirming the causal role of EJR's coverage.

To reinforce the instrumental variables approach, I next perform a set of falsification tests. I create a counterfactual setting to examine how S&P would have reacted had EJR not initiated coverage of the firm and find that S&P does not improve its ratings quality in this setting. Lastly, a propensity score matching method is employed and shows that the improvement in S&P's ratings quality is unique to firms that are actually covered by EJR and is not present for firms with similar characteristics that do not have EJR's coverage. These two approaches further confirm the causal effect of EJR's coverage on S&P's ratings quality.

Why did S&P's ratings quality respond to EJR's coverage? On the one hand, S&P may simply learn EJR's ratings and update its evaluations accordingly to mimic EJR's ratings. Alternatively, EJR's coverage may have elevated S&P's reputational concerns, which in turn strengthens S&P's incentives to provide high-quality ratings. While the "learning" channel predicts a symmetric response by S&P to EJR's lower (less issuer-friendly) and higher (more issuer-friendly) ratings, the "incentive/reputation" channel might predict a stronger response by S&P to EJR's lower ratings than to its higher ratings. This is because EJR's lower ratings indicate S&P's failure to sufficiently reveal negative credit information (i.e., overrating). To the extent that overrating is associated with a higher reputation cost than underrating (e.g., [Kisgen, 2007](#); [Ellul, Jotikasthira, and Lundblad, 2011](#)), I expect S&P to adjust its ratings more substantially in the face of EJR's lower ratings to avoid the particularly high reputation cost in this situation ([Bolton, Freixas, and Shapiro, 2012](#)). Indeed, I find a stronger response by S&P to EJR's lower ratings.

<sup>2</sup> Specifically, Fitch provides a favorable rating that serves as a tiebreaker when ratings of S&P and Moody's are on opposite sides of the investment-speculative grade boundary.

<sup>3</sup> I explicitly examine the exclusion restriction in detail in [Section 5](#) and provide suggestive evidence that the industry-level market capitalization is independent of S&P's ratings informativeness for a particular firm.

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