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Does rating analyst subjectivity affect corporate debt pricing?☆

Cesare Fracassi[a], Stefan Petry[b], Geoffrey Tate[c,*]

[a] University of Texas, Austin, TX, United States
[b] University of Melbourne, Melbourne, Australia
[c] University of North Carolina, Kenan-Flagler Business School, CB 3490, McColl Building, Chapel Hill, NC 27599-3490, United States

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ABSTRACT

We find evidence of systematic optimism and pessimism among credit analysts, comparing contemporaneous ratings of the same firm across rating agencies. These differences in perspectives carry through to debt prices and negatively predict future changes in credit spreads, consistent with mispricing. Moreover, the pricing effects are the largest among firms that are the most opaque, likely exacerbating financing constraints. We find that masters of business administration (MBAs) provide higher quality ratings. However, optimism increases and accuracy decreases with tenure covering the firm. Our analysis demonstrates the role analysts play in shaping investor expectations and its effect on corporate debt markets.

1. Introduction

Credit ratings provide a prominent public signal of credit quality. As a result, the analysts who generate those ratings can have an important influence on investors' expectations. We construct a novel data set that links long-term corporate issuer ratings from all three major rating agencies to the individual analysts responsible for each rating. We find evidence of significant analyst fixed effects on firms' long-term credit ratings that cannot be explained by firm, time, or agency effects. These fixed differences in perspectives carry through to the cost of debt capital, particularly among information-sensitive firms.

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* Corresponding author. Tel.: +1 919 962 7182; fax: +1 919 962 2068.
E-mail address: Geoffrey_Tate@kenan-flagler.unc.edu (G. Tate).

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In the presence of search or information frictions, ratings analysts can provide a valuable service to investors by aggregating and processing information. If no differences exist in how analysts perform this service, then the assignment of analysts to covered firms will not matter for ratings, even though ratings inform the market. But, if analysts have persistent differences in ability or perspectives, then the assignment of analysts to firms can lead to systematic and predictable differences in ratings. These differences in ratings, in turn, can lead to differences in debt prices if arbitrage is limited and market participants cannot filter them from information.

Individual analysts have several opportunities to affect ratings. When an issuer requests a rating, the rating agency assigns a small team of analysts to cover the firm. After a pre-evaluation, the analysts meet with the firm's management to review relevant information. They then propose a rating to a rating committee, which votes on the rating. Before issuing a press release announcing the rating, the agency notifies the firm of the rating and provides a rationale.[1] Thus, analysts have not only substantial discretion in the evaluation of the firm, but also multiple opportunities for direct communication with management. A firm can be assigned analysts who tend to be pessimistic or optimistic. In addition, repeated interactions with management can create the potential for conflicts of interest or bias arising from familiarity with the rated firm.[2]

We test for evidence of analyst discretion on ratings and debt prices in two steps. First, we measure the fixed effects of individual analysts on long-term credit ratings. To correct for nonrandom matching of analysts to the firms they cover, we include fixed effects for each firm-quarter in our regressions. Thus, we compare each analyst's rating only with peers who rate the same company at the same time and average across the firm-quarters in which we see each analyst. As a result, our estimates of analyst effects are orthogonal to differences in observed firm fundamentals. We also separate the effect of individual analysts from the effect of different agencies for which they work by including fixed effects for each of the three major rating agencies. Alternatively, we allow for quarter-by-quarter differences in how each agency rates different sectors or for fixed agency effects on the rating of each sample firm. In all cases, we find significant analyst-specific effects on ratings. The estimates are also economically meaningful. Analyst fixed effects explain 26.81–30.24% of the contemporaneous variation in ratings across agencies covering the same firm, an order of magnitude larger than the explanatory power of agency fixed effects. Moreover, they are difficult to explain by differences in the quality of private information available to analysts covering the same firms, as private information is likely to be good for some firms covered by a given analyst but bad for others. Instead, the fixed effects capture a systematic tendency for analysts to be relatively more optimistic or pessimistic than peers across the firms that they rate.

Second, we measure the degree to which these analyst effects carry through to firms' costs of capital. To avoid the possibility of reverse causality, we reestimate each analyst's fixed effect on ratings quarter by quarter on a backward-looking sample. We then decompose the firm's observed credit rating into the portion determined by the fixed effects of the analysts covering the firm in that quarter and the residual rating. We find that both portions of the credit rating significantly predict spreads on the firm's outstanding debt. In our baseline specification, a one notch increment to residual ratings changes spreads by 49 basis points while a one notch increment to the portion of ratings due to differences in analysts' perspectives changes spreads by 35 basis points. The difference is statistically significant, suggesting that the market views the portion of ratings due to fixed differences in analyst perspectives to be less informative about credit quality than the remainder of ratings. We find similar pricing effects among new issues of public debt. A one notch increment to the analyst-driven portion of ratings changes the offering yield-to-maturity by 25 basis points, compared with 29 basis points for a one notch increment to residual ratings.

We identify several sources of cross-sectional variation in the extent to which the market prices analyst fixed effects into bond spreads. We find that the market fully adjusts for analyst effects in ratings when pricing highly rated bonds (the estimate on the analyst effects is zero) but makes no significant adjustment among lower quality bonds. This result could reflect trading restrictions faced by institutional investors that limit arbitrage pressure or the relative difficulty faced by market participants in filtering information from noise among low-rated firms. To test the second mechanism explicitly, we construct five firm-level measures of information opacity: firm size, firm age, firm scope, the breadth of equity analyst coverage, and the variation in analysts' earnings forecasts. Among opaque firms, we find that analyst fixed effects exert a stronger influence on bond prices. Moreover, the difference between the impact of analyst effects and the residual portion of ratings on prices is smaller. Finally, we consider variation across firms in the information produced by the rating agencies. Among firms covered by multiple agencies and for which, as a result, more reports are available, we find that the market prices significantly less of the analyst fixed effect.

We also consider the dynamics of debt prices. We find little evidence that the residual portion of ratings is significantly associated with future changes in credit spreads, even though it strongly predicts current spreads (more so than analyst fixed effects). This result suggests that analysts do inform the market. On the other hand, systematic analyst optimism (pessimism) in ratings predicts an increase (decrease) in spreads over the following quarters, suggesting that the pricing of analyst fixed effects does not reflect the incorporation of information into prices.

Given the significance of analyst perspectives to debt pricing, our final step is to investigate the extent to which

[1] See, e.g., https://www.spratings.com/about/about-credit-ratings/ratings-process.html for a description of the process at Standard and Poor's.

[2] Rating agencies were exempted from the provisions of Regulation FD prohibiting disclosure of private information to select individuals or groups, recognizing the exchange of information between agencies and issuers. Although this exemption ended with the passage of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Purda, 2011), the practical effect on the relationships between agencies and rated firms remains unclear.