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Revolving doors on Wall Street☆

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ABSTRACT

Credit analysts often leave rating agencies to work at firms they rate. We use benchmark rating agencies as counterfactuals to measure rating inflation in a difference-in-differences framework and find that transitioning analysts award inflated ratings to their future employers before switching jobs. We find no evidence that analysts inflate ratings of other firms they rate. Market based measures of hiring firms' credit quality further indicate that transitioning analysts' inflated ratings become less informative. We conclude that conflicts of interest at the analyst level distort credit ratings. More broadly, our results shed light on the economic consequences of revolving doors.

1. Introduction

Existing literature on credit ratings distortion focuses on two main themes: problems associated with the issuer-pays business model and problems associated with regulatory reliance on credit ratings. Because subjectivity at the individual analyst level plays an important role in determining ratings (Fracassi, Petry, and Tate, 2015), we hypothesize that analyst-level conflicts of interest are another potential source of distortion. Former U.S. representative Barney Frank describes one way analysts' conflicts could emerge: "You are rating someone and then you want to go work for them and make much more money—the notion that you would be critical of some entity and then hope they hire you goes against what we know about human nature" (Wall Street Journal, Dec 02, 2011, p. C.1). If such conflicts of interest affect ratings, then we should observe ratings distortion prior to analysts' transitions to firms they rate (covered companies). However, the economics of this

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revolving door are unclear. If all analysts inflate ratings all the time, the effect is neither measurable nor sustainable.[1] We examine empirically the existence and nuances of this revolving door from credit rating agencies (CRAs) to covered companies.

Identifying revolving door effects is challenging because most settings do not provide observable counterfactuals, i.e., outcomes that would have happened in the absence of employment transfers. Without reliable counterfactuals, studies of revolving doors and similar quid pro quo dynamics face a matching problem whereby agents match based on unobservable factors. These studies, therefore, tend to overestimate the sensitivity of rewards to favors.[2] Employment transfers in the credit rating industry provide a useful and unique laboratory to address this challenge.[3] Because firms are typically rated by analysts from multiple CRAs, we use non-transitioning analysts' ratings as benchmarks to identify abnormal ratings. Unlike individuals from opposing political parties whose objectives are in sharp contrast, analysts at major CRAs have similar objectives in their credit analysis.

We identify a revolving door effect by comparing through event time ratings produced by transitioning analysts with benchmark ratings in a difference-in-differences framework. We find evidence that transitioning analysts award inflated ratings to their future employers, prior to switching jobs. In the full sample, the difference between the ratings awarded by transitioning analysts and their benchmarks changes by an average of 0.18–0.23 notches (significant at 5%) in the period preceding transitions, controlling for a number of fixed effects. The magnitude of this average effect is comparable to the 0.19 notch competitive effect on ratings found by Becker and Milbourn (2011). However, this revolving door effect is neither uniform nor random. Not only are our results concentrated in the financial services sector, the revolving door effect also appears strongest when analysts transition to the most lucrative positions (to managerial positions, large financial institutions, and prestigious investment banks). Given that financial institutions' funding costs, reserve requirements, and counterparty collateral requirements rely on their credit ratings, these results suggest a potentially material economic impact.

We conduct two supplementary analyses. We benchmark ratings against objective, market-based measures of credit risk and find that the more favorable ratings produced by transitioning analysts also become less informative in the period prior to transition. We investigate whether CRAs reverse the ratings inflation ex post and find evidence that the inflation is reversed significantly, but not fully, following the departure of the conflicted analyst. These results corroborate a revolving door effect: transitioning analysts award inflated and less informative ratings, and this inflation is largely reversed after their departure.

The revolving door hypothesis further suggests that the inflated ratings reflect conflicts of interest, not benign optimism or honest mistakes. We examine the possibility that transitioning analysts become more optimistic in general, or simply more mistake-prone, than their benchmarks in the period prior to their transitions. We find no evidence of rating inflation in the other firms rated by transitioning analysts. The rating inflation is both specific to the covered companies hiring the analysts and specific to the period preceding transition. For other rated firms and in other time periods, transitioning analysts' ratings are not distinguishable from (i.e., not more favorable than and at least as informative as) their benchmarks. Because transitioning analysts are neither generally optimistic nor especially mistake-prone, we conclude that our baseline results reflect a revolving door effect.

We consider several additional concerns. For example, an important assumption underlying the revolving door hypothesis is that individual credit analysts impact corporate bond ratings. This is not obvious because corporate bond ratings are generally assigned by a committee. We rely on the results of Fracassi, Petry, and Tate (2015), which demonstrate the significant impact of individual analysts. Furthermore, any muting influence of other members on rating committees should make it harder to find our results. Second, our sample period immediately follows the financial crisis of 2008. As such, our revolving door effect could be an artifact of changes in rating standards in response to changing economic conditions. We conduct placebo tests to address this possibility and conclude it does not explain our results. Finally, our analysis benefits from a redacted sample of analysts who took jobs at firms they did not help rate. We find no evidence of the revolving door effect in the redacted sample. Our results are uniquely tied to the conflict of interest preceding analyst transfers. This finding further supports our conclusion that our results reflect a revolving door effect.

Our results are timely given the substantial role of credit ratings in the economy and the current legislative effort to reform this industry.[4] Although we conclude that rating analysts lose objectivity in their assessment of potential future employers, we do not conclude that transfers from CRAs to covered companies should be prohibited. Such restrictions would likely lower average ratings quality, assuming CRAs cannot recruit talent if rating analysts have no career mobility. Existing rules for auditors provide a compromise. Auditors must wait two years before joining audit committees of the firms they formerly audited;

[1] In this sense, the conflict of interest is similar to the tipping hypothesis tested by Irvine, Lipson, and Puckett (2007).

[2] Consider the economic effects of lobbying or campaign donations, for example. Individuals who donate to Republicans are fundamentally different from those who donate to Democrats or those who do not donate. Thus, a correlation between campaign contributions and political favors does not necessarily indicate that donations purchase favors. Donors and politicians share ideologies that help explain both donations and the apparent favors.

[3] CRAs serve a quasi-regulatory role as gatekeepers to capital markets. See Faulkender and Petersen (2006), Kisgen (2006), White (2010), Ellul, Jotikasthira, and Lundblad (2011), and Bongaerts, Cremers, and Goetzman (2012).

[4] For evidence of real economic effects of credit ratings, see Kisgen (2009, 2012), Tang (2009), Sufi (2009), Manso (2013) and Cornaggia, Cornaggia, and Israelsen (2015a). The SEC Office of Credit Ratings opened on June 18, 2012. More information about this new department is available at http://www.sec.gov/about/offices/ocr.shtml.