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A tale of two intermediaries: A discussion of Johnston, Markov and Ramnath (2009), and Cheng and Neamtiu (2009)

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ABSTRACT

Cheng and Neamtiu examine whether credit rating agencies exploit market power to sell a substandard product. Their evidence is suggestive, but plausible alternative hypotheses could explain their results. Johnston, Markov and Ramnath provide first evidence on the bond and firm characteristics that determine the quantity of sell-side debt analyst coverage that a corporate bond receives. They also find that debt analysts anticipate credit rating changes and add information to markets incremental to credit ratings, suggesting debt analysts will be important to future research on bond markets. These results also suggest a method for refining tests of rating agency market power.

1. Introduction

The papers under discussion address the functioning of different corporate bond market intermediaries. One paper examines sell-side debt analysts and the other credit rating agencies. While there is a voluminous literature on equity market intermediaries, the literature on bond market intermediaries is relatively small. Both papers thus provide much-needed insight into a \$9.4 trillion market about which there has been too little academic research.[1]

The paper by Johnston et al. (2009) is the more novel of the two papers because it is the very first to study sell-side debt analysts. As such, it is mostly descriptive, providing information on what determines the amount of analyst coverage a given corporate bond issue receives. In addition, it demonstrates that debt analyst reports impact market prices, indicating that these intermediaries provide useful, value-relevant information to markets. Johnston et al. also provide some evidence that debt analysts are able to anticipate credit rating downgrades.

Johnston et al.'s findings are significant because they identify a previously ignored intermediary that provides value-relevant information to credit markets. Their results provide insight into the role of this new intermediary, and how it overlaps with and contrasts with the role of rating agencies, as I discuss below in Section 2. They also show that there exists significant cross-sectional variation in debt analyst coverage. Hence the results of Johnston et al. indicate that debt analysts will likely prove useful for future research on price formation in the credit markets. Debt analysts will also likely provide a

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[1] The Federal Reserve Board (2008) Flow of Funds Accounts report the following: as of December 2007, there were \$3.5 trillion in face value of corporate bonds outstanding in the non-financial sector (Table L.212, line 2) and \$5.9 trillion in the financial sector (line 4).

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useful point of reference for comparison when studying other information intermediaries in credit markets, such as rating agencies, as I discuss in Section 4.

Cheng and Neamtiu (2009) contribute to a literature that is less unexplored, on rating agencies, so their paper is more narrowly focused. They study how rating agencies changed their behavior after receiving heavy criticism in the financial press and regulatory threats from Congress during the early part of this decade. They claim to find that agencies unambiguously improved their product, increasing the timeliness and accuracy of corporate bond ratings without increasing rating volatility. The authors conclude that during the pre-threat period, rating agencies enjoyed excessive market power and used it to live the quiet life, putting out a substandard corporate bond rating product and underserving their customers. Their product improved only when they faced threats to this market power.

As I discuss in Section 4, Cheng and Neamtiu's findings and conclusion are suspect. Plausible alternative hypotheses could explain the evidence the authors present to support their claim that rating agencies improved the quality of their corporate bond ratings. Furthermore, even if this product's quality actually improved, there are factors other than a threat to market power that might be responsible, which the authors fail to consider. Nevertheless, their results are highly suggestive and will likely spur future research into the question of rating agency market power. This issue is particularly timely and deserving of research as rating agencies are currently coming under intense fire for allegedly systematically underestimating the default risk of a different class of debt instrument, mortgage-backed securities (e.g., Davies, 2008). Regulators and policy makers would surely like to know whether rating agencies use their market power to live the quiet life, as other financial intermediaries with substantial market power have been known to do (e.g., Berger and Hannan, 1998). In Section 4, I outline how future researchers might use data on debt analysts to disentangle the market power hypothesis from plausible alternative explanations of Cheng and Neamtiu's results.

The rest of this article is organized as follows. In Section 2, I discuss the two bond market intermediaries of interest and compare and contrast their roles in the bond market, and how the findings of Johnston et al. shed some light on these roles. In Section 3, I discuss the Johnston et al. paper in greater detail. In Section 4, I discuss Cheng and Neamtiu's paper in detail. In Section 5, I conclude by summarizing the most important and relevant insights the two papers provide and by giving suggestions for future research in the area of credit market information intermediaries.

2. The role of sell-side debt analysts contrasted with credit rating agencies

Both rating agencies and debt analysts provide investors with information on corporate bonds. The type of information they provide is also similar, though not exactly the same. Rating agencies' primary mission is to assess default risk. Debt analysts, in addition to evaluating bond default risk, also recommend corporate bonds as investment opportunities for investors, the bulk of which are institutions. Since bonds have limited upside, assessment of default risk is among the most important aspects of analyzing a bond's attractiveness as an investment opportunity. This important task is performed by both rating agencies and bond analysts.

The similarities between the two intermediaries largely end there, however. There is more to analyzing a bond as an investment opportunity than merely evaluating its credit risk. Bond analysts care about potential for price appreciation, exposure to interest rate risk, exposure to call risk, and other aspects of bonds that rating agencies might ignore. Thus bond analyst reports are likely to contain information not contained in credit ratings. Supporting this notion, Johnston et al. find that analyst reports published after credit rating changes have a significant market impact, demonstrating that bond analysts add information to markets in addition to what is contained in credit ratings.

Credit rating agencies, however, have a significant advantage over bond analysts: access to private information. Since Reg FD, bond analysts have had to base their analysis solely on what bond issuers disclosed to the public. Bond issuers, however, routinely disclose private information to rating agencies, who use it to determine their ratings, but otherwise agree to keep it confidential. As a result, credit rating changes are likely to contain some value-relevant information that bond analyst reports miss. Consistent with this idea, Johnston et al. find that the market reaction to a rating downgrade is larger in magnitude than the reaction to analyst reports published soon before it.

Unlike bond analysts, rating agencies operate in an oligopolistic market, with only three major players, whereas there are dozens of security firms that provide sell-side bond research. Thus rating agencies, unlike bond analysts, likely enjoy some market power. The importance of this market power, and the implications it may have for regulation, if any, is the focus of Cheng and Neamtiu.

Finally, rating agencies have a broader audience than sell-side bond analysts. Bond analysts produce information primarily for bond investors. While investors do use credit ratings and reports put out by rating agencies, there are many other users of the information that rating agencies generate. Credit ratings are often referenced in contracts, such as those of an investment grade bond fund, and regulators use credit ratings to prevent regulated entities, such as pension funds, from taking excessive risks (e.g., SEC, 2003). It has even been proposed that bank regulators use subordinated debt credit ratings (e.g., Hancock and Kwast, 2001). Because of the regulatory and contractual uses of credit ratings, rating agencies are likely more concerned with the stability of their ratings, giving them an incentive to make them less timely than bond analyst reports. Consistent with this notion, Johnston et al. find that debt analysts appear to report on the deterioration of credit quality more quickly than rating agencies publish a rating downgrade.