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Impact of the Dodd-Frank act on credit ratings[☆]

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ABSTRACT

We analyze the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) on corporate bond ratings issued by credit rating agencies (CRAs). We find no evidence that Dodd-Frank disciplines CRAs to provide more accurate and informative credit ratings. Instead, following Dodd-Frank, CRAs issue lower ratings, give more false warnings, and issue downgrades that are less informative. These results are consistent with the reputation model of Morris (2001), and suggest that CRAs become more protective of their reputation following the passage of Dodd-Frank. Consistent with Morris (2001), we find that our results are stronger for industries with low Fitch market share, where Moody's and Standard & Poor's have stronger incentives to protect their reputation (Becker and Milbourn, 2011). Our results are not driven by business cycle effects or firm characteristics, and strengthen as the uncertainty regarding the passage of Dodd-Frank gets resolved. We conclude that increasing the legal and regulatory costs to CRAs might have an adverse effect on the quality of credit ratings.

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> *"By imposing structural, regulatory, and liability reforms on rating agencies, this agreement will change the way nationally recognized statistical rating organizations behave and ensure that they effectively perform their functions as market gatekeepers going forward."*
>
> Congressman Paul Kanjorski (PA)[1]

1. Introduction

The mass defaults of highly rated structured finance products in 2007 and 2008 has led to a renewed focus on the quality of ratings issued by credit rating agencies (CRAs). Many observers partly blame CRAs' inflated ratings of structured finance products for the rapid growth and subsequent collapse of the shadow banking system, which was at the epicenter of the global recession of 2008–2009 (see, for e.g., Blinder, 2007; Stiglitz, 2008; Brunnermeier, 2009).

In response to the financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) in July 2010. Dodd-Frank outlines a series of broad reforms to the CRA market but delegates the responsibility of developing specific rules to the Securities and Exchange Commission (SEC) and other federal agencies.[2]

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[1] "Dodd-Frank Wall Street Reform and Consumer Protection Act." Congressional Record 156: 100 (June 20, 2010), p. H5238.

[2] Appendix A contains a summary of all provisions of the law concerning CRAs.

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As a result, provisions mandating internal control and governance reform are yet to be finalized as of April 2014. Provisions eliminating regulatory reliance on credit ratings have been implemented as recently as 2013. Nevertheless, two important provisions become effective immediately with the passage of the law. First, Dodd-Frank significantly increases CRAs' liability for issuing inaccurate ratings by lessening the pleading standards for private actions against CRAs under Rule 10b-5 of the Securities and Exchange Act of 1934. Second, the law makes it easier for the SEC to impose sanctions on CRAs and to bring claims against CRAs for material misstatements and fraud.

We test two hypotheses on the impact of Dodd-Frank on credit ratings. According to the *disciplining hypothesis,* Dodd-Frank achieves its stated objective of improving the quality of credit ratings. The increase in legal and regulatory penalties for issuing inaccurate ratings may encourage CRAs to invest in due diligence, to improve their methodology, and to better monitor the performance of their credit analysts. These changes could lead to more accurate and informative credit ratings. Credit ratings may improve further as CRAs strengthen internal control and corporate governance mechanisms, although this effect is likely to be muted given the uncertainty regarding the SEC's final rules.

Alternatively, the increase in legal and regulatory penalties under Dodd-Frank can have an adverse effect on the quality of credit ratings. The reason is that these penalties are asymmetric, whereas CRAs are penalized for optimistically biased ratings but not for pessimistically biased ratings (Goel and Thakor, 2011). For example, having an investment-grade rating for an issuer that subsequently defaults is likely to subject CRAs to legal or regulatory action. In contrast, neither investors nor the SEC are likely to challenge a speculative-grade rating for an issuer that remains solvent. Dodd-Frank makes optimistic ratings costlier for CRAs because optimistic ratings are more likely to be perceived as optimistically biased, inviting legal and regulatory scrutiny. To protect (or rebuild) their reputation, CRAs may respond by lowering their ratings beyond a level justified by an issuer's fundamentals (Morris, 2001). We call this the *reputation hypothesis*. As CRAs lower their ratings regardless of their information, investors rationally discount CRAs' rating downgrades. The result is that some of the private information of CRA analysts is lost to the market.[3]

The reputation hypothesis makes three empirical predictions: (1) all else equal, CRAs issue lower credit ratings following Dodd-Frank; (2) all else equal, there are more false warnings (i.e., speculative grade rated issues that do not default within a year) following Dodd-Frank; and (3) all else equal, credit rating downgrades become less informative following Dodd-Frank. In contrast, the disciplining hypothesis predicts that credit ratings become more accurate and more informative following Dodd-Frank, directly opposing predictions (2) and (3) of the reputation hypothesis.

Using a comprehensive sample of corporate bond credit ratings from 2006 to 2012, we find results that provide strong support for the reputation hypothesis. First, we find that bond ratings are lower, on average, in the post-Dodd-Frank period (defined as the period from July 2010 to May 2012). The odds that a corporate bond is rated as non-investment grade are 1.19 times greater after the passage of Dodd-Frank, holding all else constant. Second, we find more false warnings in the post-Dodd-Frank period, where false warnings are defined as speculative grade rated issues that do not default within one year. The odds of a false warning are 1.84 times greater after the passage of Dodd-Frank, holding all else constant. Third, we find that the bond market responds less to rating downgrades in the post-Dodd-Frank period. Prior to the passage of Dodd-Frank, bond prices decrease on average by 1.023% following a rating downgrade; this compares to a decrease of 0.654% following the passage of Dodd-Frank. In contrast, the bond market's response to rating upgrades remains the same. Fourth, we find that the stock market also responds less to rating downgrades in the post-Dodd-Frank period. Stock prices decrease by 2.461% following a rating downgrade in the pre-Dodd-Frank period; in the post-Dodd-Frank period, the decrease is only 1.248%. Taken together, these results show that rating downgrades are less informative in the post-Dodd-Frank period as the market discounts the actions of CRAs meant to protect their reputation. It appears that the reputation effect outweighs the disciplining effect of Dodd-Frank in the market for corporate bond credit ratings.

We provide additional evidence in support of the reputation hypothesis by examining whether the above results vary with variations in the CRAs' ex ante reputation costs. Becker and Milbourn (2011) show that CRAs invest more in reputation when they face less intense competition. Using Fitch's entry into the CRA market as a competitive shock, Becker and Milbourn (2011) show that increased competition from Fitch coincides with lower quality ratings from the incumbent CRAs (Moody's and Standard and Poor's (S&P)).[4] By decreasing expected rents in the industry, competition decreases incumbents' incentives to invest in reputation for accurate ratings. We expect that, following the passage of Dodd-Frank, the ratings of Moody's and S&P are lower, less accurate, and less informative within industries with lower Fitch market share. When Fitch's market share is lower, legal and regulatory penalties have higher expected costs to Moody's and S&P

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[3] Morris (2001) provides an example of the reputation effect in the context of political correctness, wherein an informed social scientist advises an uninformed policy maker on the merits of affirmative action by race. The social scientist makes the politically correct recommendation of affirmative action regardless of whether she believes this is indeed the right policy choice. This is because the social scientist does not want to be perceived as being racist. In equilibrium, the social scientist's information is lost. The formal model of Morris (2001) builds on the earlier conceptual work by Loury (1993).

[4] Becker and Milbourn (2011) show convincingly that Fitch's market share within an industry is exogenous to industry characteristics and the quality of credit ratings. For example, Fitch's market share in an industry is unrelated to credit growth in the industry, industry profitability, and the difficulty of predicting default within the industry. Fitch's market share is also unrelated to the coverage provided by Moody's and S&P, who rate virtually all corporate issues.

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