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How did increased competition affect credit ratings? ☆

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ABSTRACT

The credit rating industry has historically been dominated by just two agencies, Moody's and Standard & Poor's, leading to long-standing legislative and regulatory calls for increased competition. The material entry of a third rating agency (Fitch) to the competitive landscape offers a unique experiment to empirically examine how increased competition affects the credit ratings market. What we find is relatively troubling. Specifically, we discover that increased competition from Fitch coincides with lower quality ratings from the incumbents: Rating levels went up, the correlation between ratings and market-implied yields fell, and the ability of ratings to predict default deteriorated. We offer several possible explanations for these findings that are linked to existing theories.

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1. Introduction

Credit ratings make information about default likelihoods and recovery rates of a security widely available, limiting duplication of effort in financial markets. They allow uninformed investors to quickly assess the broad risk properties of tens of thousands of individual securities using a single and well-known scale.[1] In addition, ratings are relied on extensively in regulation and private contracting, as a tool for measuring and limiting risk. For example, commercial banks, insurance companies and pension funds are among the institutions facing regulatory rules based on credit ratings. Many investors can hold securities only with investment-grade ratings (e.g., pension funds, money market funds) or are required to use different amounts of capital based on the ratings of securities they hold (e.g., insurance companies). For these reasons, ratings constitute a key channel of information

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[1] The majority of corporate security ratings relate to corporate bonds. Other corporate securities, such as preferred stock, are frequently rated as well, as are government bonds (at the municipal, state and federal levels) and structured financial products (such as residential mortgage-back securities, collateralized mortgage obligations, collateralized debt obligations, etc.). See Table 2 for an overview of ratings categories.

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dissemination in financial markets and are considered important by legislators, regulators, issuers, and investors alike.[2] The quality of ratings is, therefore, relevant for the proper functioning of the financial system.

While the importance of a viable ratings industry seems clear, the provision of accurate ratings is made more complicated by the peculiar market structure of the industry. First, the industry is dominated by only three players – Moody's, Standard & Poor's (S&P), and Fitch Ratings – with Fitch gaining prominence only in the past decade or so.[3] Second, ratings issued mainly by these agencies are paid for by the firms being rated. Once produced, ratings are made publicly available and investors that rely on them use them for free. Users of ratings, such as investors who consider buying a security, desire accurate ratings. However, firms whose securities are rated prefer favorable ratings as it directly lowers their cost of capital, and they do not necessarily prefer accurate ones. Because rating agencies' revenues come from issuers, a basic tension exists between the desire of raters to please individual paying customers and the raters' need to maintain the overall precision and informativeness of credit ratings.

These industry features have raised questions about the quality of the ratings provided by these incumbent players. In particular, a broad consensus exists among policy makers and regulators around the potential benefits of increasing competition between ratings providers as a tool for improving ratings quality. For example, Paul Schott Stevens, president of the Investment Company Institute, stated: "I firmly believe that robust competition for the credit rating industry is the best way to promote the continued integrity and reliability of their ratings" in testimony before the US Senate Committee on Banking, Housing, and Urban Affairs.[4] The empirical merits of this push for competition are not at all well established, and because of the informationally opaque setting, the theoretical predictions are ambiguous as well.

In this paper, we wish to examine the effect of increased competition in the ratings industry and shed some light on the issue of whether or not it tends to improve the quality of ratings. The corporate debt ratings industry offers a clear instance of increased intertemporal competition as Fitch grew into a credible player perched to compete with the two incumbents in the corporate debt market, namely, Moody's and Standard & Poor's. Founded in 1913, Fitch's roots are as old as these main agencies, but it remained a markedly smaller player until 1989 when a new management team recapitalized Fitch. This was followed by a merger in 1997 with IBCA Limited, which specialized in coverage of financial institutions. "The merger of Fitch and IBCA represented the first step in our plan to respond to investors' needs for an alternative global, full-service ratings agency capable of successfully competing with Moody's and S&P across all products and market segments."[5] Fitch's continued growth from this year forward was both organic and inorganic, including the acquisitions of Duff & Phelps Credit Rating (American) and Thomson Bankwatch (Canadian) in 2000. Fig. 1 characterizes the evolution of Fitch Ratings over time (Fitch Ratings, 2002).

The emergence of Fitch as a larger player manifested itself in a significant increase in their market share. We measure the market presence of Fitch by the fraction of all bond ratings in a particular industry over a period of time (a month or a year) that are provided by Fitch. Fig. 2 shows that over the decade that we study, starting in the mid-1990s, Fitch's share of corporate bond ratings increased substantially. In the median industry, Fitch issued less than one in ten ratings in 1997, but approximately a third of ratings by 2007. Critical to the construction of our empirical tests is the fact that Fitch's growth in the corporate ratings market has varied considerably across industries. The range of market shares can be seen from the 25th and 75th percentile lines plotted in Fig. 2.[6] Table 1 lists Fitch's market share by industry, comparing the average for the earlier half of our sample (1995–2000) and the later half (2001–2006). By the end of the sample, Fitch was particularly prominent in finance, utilities, public administration, real estate, and retail. Fitch remained relatively less represented in agriculture, entertainment, other services, and transport. The largest gains during the sample occurred in accommodation and food services, real estate, construction, waste management, and retail.

Such increased market presence across a wide array of industries did not go unnoticed by the users of ratings, and institutional acceptance of Fitch's corporate ratings was cemented by the July 1, 2005 inclusion into the Lehman (now Barclays Capital) Index that differentiates between investment-grade and junk (high-yield) bonds (see Chen, Lookman, Schürhoff, and Seppi, 2010). Prior to this change, Lehman assigned the lower of Moody's or S&P rating to any corporate bond, and thus in situations in which one of these two incumbents placed a bond below investment grade (e.g., BB+) while the other placed it above (e.g., BBB−), the bond would necessarily be classified as part of the junkbond index. After this move to include Fitch's ratings as part of the classification, index classification was determined by the middle of the three

[2] See Graham and Harvey (2001) for a survey of financial executives' attitudes toward credit ratings, Campbell and Taksler (2003) for recent evidence on the effect of ratings on corporate bond prices, and Tang (2006) for the information transmission of ratings. Kisgen (2006) shows how firm capital structure decisions are affected by rating considerations.

[3] The Securities and Exchange Commission now designates ten firms as Nationally Recognized Statistical Ratings Agencies, thereby granting their ratings regulatory status, but the other seven firms play a much smaller role in the corporate market (http://www.sec.gov/divisions/marketreg/ratingagency.htm#nrsroorders).

[4] See http://www.financial-planning.com/asset/article/527499/fund-industry-group-calls-more-credit.html.

[5] Drawn from the statement of Nancy Stroker (Managing Director) of Fitch Ratings, to the House Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, June 29, 2005.

[6] Fig. 2 plots the 24-month rolling average of Fitch's market share in the 25th percentile, median, and 75th percentile industries. Because our sample begins in 2005, the 24-month lag means that the graph starts in 1997. The industries are listed in Table 1 (the specific industries that constitute the 25th percentile, median, and 75th percentile lines vary over time).

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