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Credit ratings quality: The perceptions of market participants and other interested parties

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ABSTRACT

The global credit crunch of 2008 and related sub-prime mortgage crisis of 2007 have made credit ratings agencies (CRAs) the focus of international attention. In particular, the quality of ratings information and the responsibilities CRAs owe to financial markets have come under intense scrutiny. Specifically, commentators, politicians, and regulators have expressed concern at the involvement CRAs might have had in creating global financial instability. However, the term ratings quality remains largely absent from the academic literature.

This paper constructs a measurement instrument to capture ratings quality provided by CRAs, and assesses differences in perceptions of ratings quality amongst four stakeholder groups in public debt markets. Two macro-constructs of ratings quality are identified, labelled Technical Qualities and Relationship Qualities. The two macro-constructs are measured by ten micro-attributes, labelled: Cooperation; Independence; Internal Processes; Issuer Orientation; Methodology; Reputation; Service Quality; Shared Values and Norms; Transparency; and Trust. Each micro-attribute is operationalised into individual items, and then empirically tested using data obtained in the UK from 121 issuers, 75 non-debt issuing financial managers, 90 investors, and 120 other interested parties.

The data suggest that ratings quality involves, in order of importance: the CRA's reputation; those values and norms of the CRA shared by users; the methodologies employed by the CRA; the independence of the CRA; and internal processes within the CRA. Multivariate analysis of variance finds no statistically significant variation between the groups for Technical Qualities factors. However, issuers rate Relationship Qualities and its micro-attributes of Trust, Issuer Orientation, and Service Quality higher than other market participants; a finding that reflects the dyadic relationship between the issuer's treasurer and lead analyst of the CRA. The paper concludes with a number of policy-relevant issues.

1. Introduction

The global credit crunch of 2008 has restricted the ability of banks to lend to one another and necessitated unprecedented government intervention in financial markets throughout the world. It is widely accepted that the antecedent of this financial crisis was the sub-prime mortgage debacle in the United States (US) of 2007 where the credit ratings agencies (CRAs) were widely implicated. Criticism of CRAs came from a wide range of stakeholders in financial markets, notably the financial community, regulatory bodies, and politicians. The severity of criticism directed at CRAs was in stark contrast to their hitherto

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low profile as mere publishers of opinion, the world's shortest editorials (Husisian, 1990). Common issues of concern included: a lack of transparency (e.g. Parker et al., 2008); flawed methodologies (IOSCO, 2008a); inherent conflicts of interest within the CRA business model (US Senate Committee, 2008); poor communication (FSA, 2008); CRA staff resourcing (CESR, 2008); and extreme product complexity resulting in a lack of understanding among users (e.g. Chung and van Duyn, 2008).

Such adverse appraisal of CRAs is not new. Critics have questioned their inability to predict financial catastrophes such as the 1997 Asian financial crisis or the well-publicised corporate failures that occurred in the early part of this century (Gonzalez et al., 2004). Furthermore, CRAs have endured criticism within the academic literature for the timeliness of their ratings (e.g. Altman and Rijken, 2004, 2006). In the light of these events where timely downgrades of ratings were not perceived to have been made, market participants, regulators and professional bodies have become more interested in the function and operation of CRAs; e.g. the Securities and Exchange Commission in the US (SEC, 2003a,b). In response to these ongoing discussions, the US has recently enacted formal regulation with the Credit Rating Agency Reform Act (CRARA) of 2006. CRARA has the aim of "improving ratings quality for the protection of investors by fostering accountability, transparency and competition" (US Senate Committee, 2006). Internationally, self-regulation of the industry has found favour, with the International Organization of Securities Commissions (IOSCO, 2004) developing a Code of Conduct for CRAs (the IOSCO Code) that is supported by the Committee of European Securities Regulators (CESR) and the SEC.

In the wake of the sub-prime debacle, and related credit crisis, a range of industry and regulatory authorities have opined on the quality of the CRA ratings and the integrity of the ratings process. For example, IOSCO (2008b) have updated their Code of Conduct to address issues of transparency, independence, conflicts of interest, and competition; issues of direct relevance to this research. The Financial Stability Forum (FSF, 2008) has also made recommendations relating to the quality of the ratings process, conflicts of interest, and improvement of transparency. A CRA Task Force established by the Securities Industry and Financial Markets Association (SIFMA) has made a number of recommendations including improvements to methodological disclosure and the transparency of decision-making (SIFMA, 2008).

Finally, and most radically, the European Commission (EC) (EC, 2008) is acting to implement extensive community-wide legislation on the authorisation, operation, and supervision of the industry. Key elements of the radical EC proposal include: the creation of a unitary EC body for CRA supervision; requiring registration of all CRAs that would like their ratings to be used by banks and insurance companies in the European Union (EU); the introduction of requirements that identify how a CRA should deal with conflicts of interest; ensure ratings quality of ratings and increase transparency for ratings users; and making CRAs subject to public supervision. The relatively brief period of consultation preceding the proposal received a relatively high level of response from ratings information users.[1]

In summary, credit markets in the twenty-first century have seen a continued focus on the quality of ratings information. Despite the intensity of the debate, there remains no consensus on how it is to be achieved. To date, there has been no systematic empirical study of debt market participants' perceptions of CRAs. As CRAs function as reputational intermediaries, stakeholder views are very important with respect to credibility, as gatekeeper quality is difficult to observe directly (cf. Francis, 2004). Watkins et al. (2004) identify that gatekeeper quality is subject to a range of definitions, and most reflect some degree of market perceptions (see also Maroney et al., 2008; Zeff, 2007).

The purpose of this study is to contribute to the corporate governance and finance literatures by developing a measurement instrument to capture the quality of ratings information provided by CRAs, following a period of rapid and significant environmental change within the ratings industry. We sample four key stakeholder groups of debt issuers, non-issuing financial managers, investors, and other interested parties in April 2006, the period immediately prior to the sub-prime crisis. The theoretical model is developed using the extant quality literature which has informed analysis of other financial gatekeepers. The calibration and measurement of the components of ratings quality allows the constructs to be applied and potentially refined in empirical research considering CRAs. While there is not a strong tradition of publishing articles of this nature in corporate governance and finance research, "there is a role for new constructs for which there are no ready-made instruments available from other disciplinary areas" (van der Stede, 2001 p. 119).

Two macro-constructs of ratings quality are developed, labelled: Technical Qualities; and Relationship Qualities. They are decomposed into fourteen micro-attributes, which are operationalised into individual questionnaire items. The ratings quality model is then recomposed empirically using responses from a postal questionnaire survey administered to public debt market issuers, non-issuing corporate treasurers, bond market investors, and samples of other interested parties. The sample is representative of a broad range of market participants. Issuers engage a CRA to enable them to market the debt security at the lowest possible interest rate, thereby reducing their cost of capital. Investors wish to establish the credit quality of the rated security as part of their decision process. Non-issuing companies and other interested parties represent a broad constituency of stakeholders, who use ratings information for a wide range of purposes (e.g. investment, investment advice, securities valuation, and education and training purposes).

The remainder of this paper is organised as follows. Section two provides a literature review used to develop the hypothesised constructs of credit ratings quality. The third section outlines the sampling and data collection procedures employed. The results and discussion are presented in the fourth section. The final section summarises and concludes.

[1] 96 responses to the EC consultation were received (EC, 2008).