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Understanding credit ratings quality: Evidence from UK debt market participants

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ABSTRACT

This study seeks to identify: (i) the demand for corporate bond ratings provided by credit ratings agencies (CRAs); (ii) how issuers select CRAs; and (iii) to better understand ratings quality, a term widely used by commentators, politicians and regulators, but under-explored in the academic literature. Interviews identify the principal source of demand for rating information is to reduce agency conflicts between issuers and investors. Issuers typically engage between one and three credit ratings agencies to rate their debt, implying a heterogeneous demand for ratings services, and different levels of ratings quality. However, ratings quality extends beyond competence and independence to include factors relating to professional judgment, communication, transparency, and the quality and continuity of analytic staff. Findings were discussed in the light of the ongoing international policy debate concerning CRAs.

1. Introduction

> We live again in a two-superpower world. There is the US, and there is Moody's. The US can destroy a country by leveling it with bombs: Moody's can destroy a country by downgrading its bonds.
>
> (Friedman, 1995 cited in Sinclair, 2005)

The global credit crisis of 2008, preceded by the sub-prime mortgage crisis in the United States (US) has placed credit ratings agencies (CRAs) under the spotlight. CRAs are perceived to have failed the market (Duff and Einig, 2007) by problems in rating structured finance securities. Subsequent to the subprime debacle, issues relating to the quality of ratings have been raised by a wide range of commentators, politicians and regulators, with demands for greater regulatory measures and accountability to improve the quality of ratings work. Criticism of CRAs is hardly new, with their seeming inability to predict the 1997 Asian financial crisis or the collapse of US energy corporation Enron at the start of this century. For example, each of the three major CRAs provided Enron with investment grade ratings until just four days prior to its collapse.

Credit rating agencies (CRAs) provide an independent evaluation of the probability of default on a bond issue and review the assessment in the light of economic events. In addition, the CRAs provide information to debt market participants beyond those publicly available sources (e.g., Reiter and Zeibart, 1991; Ederington et al., 1987). Consequently, CRAs provide a valuable

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role to stakeholder groups such as issuers, investors, and regulators, allowing credit markets to function properly. For the purposes of this paper, CRAs are conceived of as the (then)[2] five Nationally Recognised Statistical Rating Organizations (NRSROs) Moody's, Standard & Poor's, Fitch, A.M. Best, and Dominion Bond Rating Services.

An aim of this paper is to apply the theoretical lens of the extensive extant financial gatekeeper literature to better understand the relationships CRAs have with issuers, investors, and other market participants. The paper makes a conceptual contribution in two ways. First, it contributes by employing interviews with 14 key credit market participants as illustration, allowing us to get closer to the theoretical constructs (Sigglekow, 2007). Second, it contributes by extending gatekeeper perspectives from the audit literature to the under-explored ratings industry.

The present study has three objectives. First, it explores demand for ratings from UK debt market participants in the United Kingdom (UK). The UK is chosen as the majority of prior research has focused on the United States (US), notable exceptions being Adams et al. (2003) and Barron et al. (1997). As recognized CRAs operate on a global basis, it is likely insights from the UK will be generalisable to other jurisdictions. The second objective is to assess how UK issuers go about commissioning a CRA to rate a debt security. The final objective is to explore issues relating to ratings quality.

The remainder of this paper is structured as follows. The following section provides a review of the literature considering ratings quality, including the contextual setting against which the results of the study are set. These include the demand for ratings information and perspectives from the financial gatekeeper literature, which have some potential to inform thinking on CRAs and ratings quality. Recent developments in regulation, self-regulation, and monitoring within the CRA industry are also considered. Section 3 identifies the research questions. Section 4 explains the method applied in the present study. The results and discussion are presented in Section 5. The final section summarizes and concludes.

2. Background

2.1. The ratings industry

According to Cantor (2004, p. 2565) research considering credit risk has been "one of the most active areas of recent financial research", with significant efforts deployed to analyse "the meaning, role, and influence of credit ratings". However, issues concerning the demand for ratings information and the conceptualization of ratings quality remain relatively unexplored (see Frost, 2006; Duff and Einig, 2007, in press).

CRAs provide a service at the invitation of client companies to provide an independent assessment of the credit quality of a company's debt security or securities.[3] The unique selling proposition of the CRA is to distil a multitude of credit information to a single letter on a credit quality scale (e.g., AAA denoting very low probability of default). Over the life of the debt security, the CRA monitors its credit quality. When creditworthiness increases an upgrade may be issued. In the case of deteriorating credit circumstances a downgrade would be issued. When the issuer has solicited the rating, CRAs have privileged access to their client's senior management and other confidential information sources. By virtue of access to unpublished information and their independence, CRA opinions are of interest to the investment community.

Our research views CRAs as comparable with suppliers of audit and assurance services, operating in an unusual economic market in which the CRA (or auditor) is a central participant, whereby a significant source of demand for ratings comes from third parties (e.g., fixed-income investors) who only pay indirectly for the required services. The client (debt issuer) is often a forced participant in the market, required by investors to engage the services of a CRA to obtain a rating of the credit quality of its securities. Auditors and CRAs are conceptualised as financial gatekeepers on whom the board of directors rely to properly advise and warn it of danger (Coffee, 2006).

Despite criticisms of the role CRAs have played in global financial markets over the past decade, paradoxically, issuers of debt securities, investors, and government regulators (e.g., the SEC in the United States (US), and the United Kingdom's (UK) Financial Services Authority) have increased their reliance on the opinions of CRAs for corporate financing, investment decisions, and risk management (Baker and Mansi, 2002). The Basel Committee on Banking Supervision has increased the role given to CRAs in its revised capital adequacy framework (Basel II) by basing its standardized approach for credit risk measurement on external credit ratings.

The ratings industry is effectively an oligopoly, dominated by two NRSROs (Moody's and S&P). Moody's and S&P account for 80% of the market, while Fitch's share is only 15% (Duff and Einig, 2007). The closest rivals to this oligopoly are A.M. Best, specializing in insurance, and Dominion Bond Rating Services, with a Canadian focus. However, it is important to note that a number of much smaller specialized CRAs exist. A recent survey of the ratings industry identifies there are more than 130 CRAs worldwide (Basel Committee, 2000). These CRAs vary considerably in terms of size, industry coverage, regional focus, and methodology.

In the US, this market structure coupled with recent perceived failures of CRAs has motivated some parties (e.g., US Congress) to create legislation to increase competition. Further issues of concern include the business model of the CRAs,

[2] From September 2007, the Securities and Exchange Commission (SEC) also recognized Japan Credit Rating Agency, Ratings and Investment Information, Egan Jones Ratings, and LACE Financial.

[3] IOSCO (2004) define CRAs as "those entities whose business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers of debt and debt-like securities".