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Are unsolicited credit ratings biased downward?

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Abstract

There has been considerable controversy over unsolicited credit ratings in recent years. Some dissatisfied issuers allege that unsolicited ratings are biased downward in contrast to solicited ratings. This is the first empirical study to analyze the controversy using pooled time-series cross-sectional data of 265 firms in 15 countries from Standard and Poor's Ratings Services (S&P's) during the period of 1998–2000. The results demonstrate that unsolicited ratings are lower. On the other hand, I also find that those issuers who choose not to obtain rating services from S&P's have weaker financial profiles. Although the difference in ratings can be explained by this significant self-selection bias, results of the Japanese sub-sample indicate that unsolicited ratings are still lower than solicited ratings after controlling for differences in sovereign risk and key financial characteristics.

JEL classification: G20; G10; G15
Keywords: Unsolicited credit ratings; Selectivity bias; Standard and Poor's ratings; Ordered-probit model

1. Introduction

Most investors who are faced with diverse investment alternatives and a broad spectrum of financial products rely on independent measures of credit quality. Credit ratings assigned by rating agencies such as Standard and Poor's Ratings Services (S&P's), Moody's Investors Service (Moody's), Duff and Phelps Credit Ratings Co. (Duff and Phelps), and Fitch Investors Service (Fitch) are widely used by

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individual investors and regulators to obtain objective quality ratings for financial instruments. These ratings, which represent rating agency opinions and risk assessments of financial instruments such as bonds and commercial paper, can seriously affect their marketability, financing costs, and loan amounts. The prices of marketable corporate debts are associated with changes in debt ratings. In fact, many countries have official regulations that require securities to have some form of rating. Over the years, credit ratings have served not only as a yardstick to measure the risk of investments, but also as a benchmark for comparison. Therefore, most companies in the US believe that having a rating from the two major rating agencies, S&P's and Moody's, is desirable, indeed indispensable for an issuer in capital markets. These companies are willing to pay for the rating services provided by credit agencies to obtain ratings on their debt instruments. Credit ratings paid for and initiated by issuers are commonly known as "solicited ratings".

However, there are still quite a number of companies in the global financial markets that "choose", for various reasons, not to be rated by these agencies. For example, some Middle Eastern bankers, such as those in Saudi Arabia, seldom raise debt or equity in international financial markets because they do not want foreign shareholders to take control of their country's banks. As net lenders in the global interbank market, they do not need to obtain credit ratings from Moody's or S&P's (Harington, 1997). In China, which has different regulatory systems and different accounting standards, officials prefer banks to be rated by local rating agencies. They consider US-based agencies, such as Moody's, are not well informed about the current situation in China to be able to make informed assessments. Other possible reasons why firms do not seek rating services are that some issuers believe that their debt issues are not up to investment-grade standard, or they do not find their own financial performance satisfactory. They fear that any rating they obtain might be low, and they wish to avoid any chance of receiving an unfavorable rating. However, despite the fact that these issuers do not actively seek credit ratings, some of them still get rated anyway. These unwelcome and unwanted ratings are usually called "unsolicited ratings".

After the first issue of unsolicited ratings by Moody's in 1991, and as the competition between rating agencies became keener, S&P's, IBCA (the London-based agency) and Fitch decided to follow the lead of Moody's in rating companies that did not request the service. Rating agencies justify their need to assign unsolicited ratings by claiming that there is a demand for them from financial markets. When an agency wishes to break into a new market, it provides unsolicited ratings and feels justified in doing so. For example, S&P's has attempted to aggressively enter the Japanese market in recent years, and it has assigned 150 unsolicited long-term credit ratings (i.e., 63% out of 237 ratings) to Japanese issuers as of January 14, 2000 (S&P's, 2000a). As independent quality rating agencies, they claim that they are serving not only the issuers but also public investors and rate issuers/issues for free whenever there is sufficient investor interest in them.

Most issuers with unfavorable, unsolicited ratings do not find agency interest in them warranted. On the contrary, many of them find these ratings unfair and offensive because they believe that the agencies cannot justify a fair rating without con-