For credit rating agencies, reputation matters

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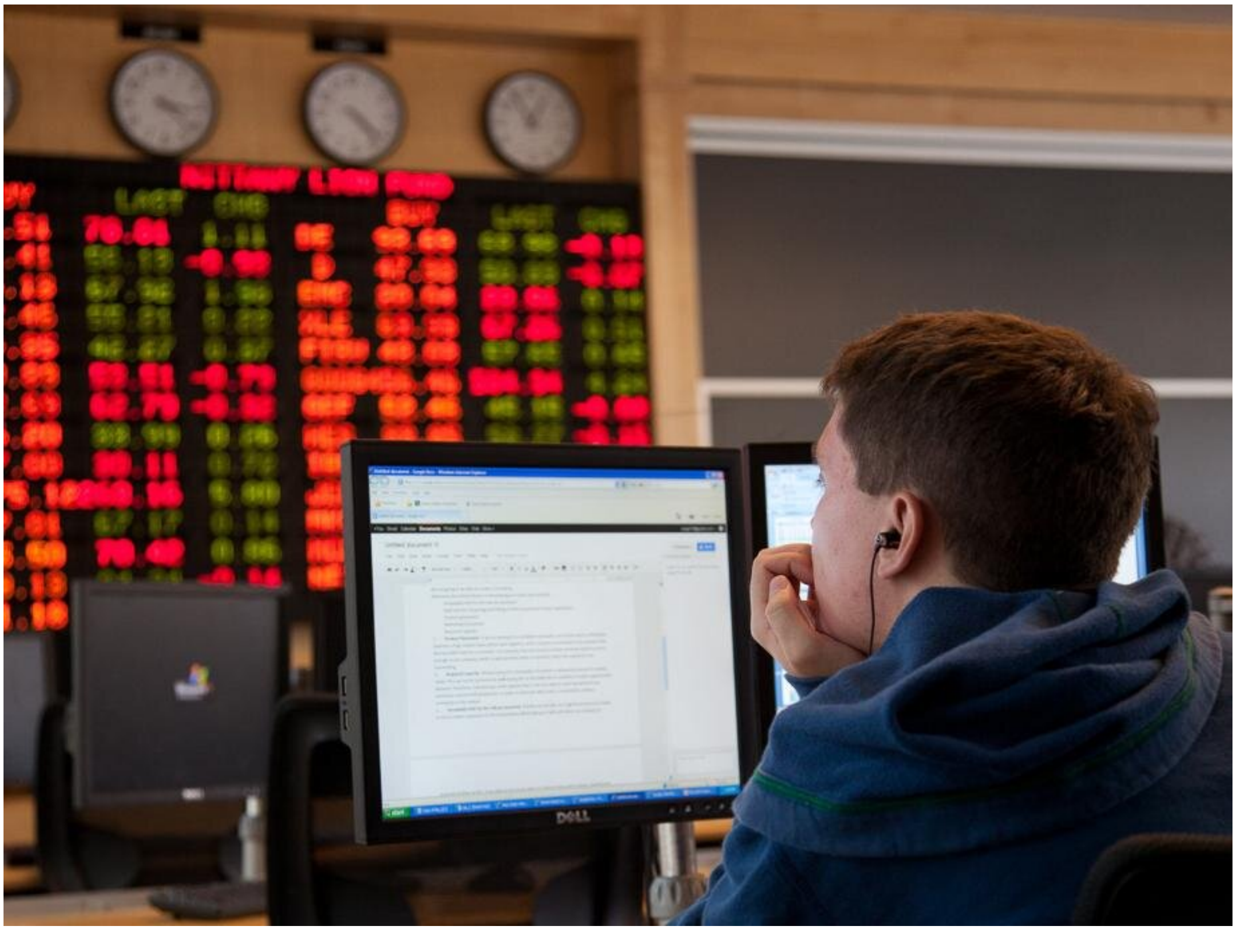

Research conducted by a pair of faculty members in the Penn State Smeal College of Business — Sam Bonsall, Deloitte & Touche Teaching Excellence Professor and professor of accounting, and Karl Muller, Robert and Sandra Poole Faculty Fellow in Accounting and associate professor of accounting — tried to answer whether credit agencies act responsibly when issuing ratings. Credit: Smeal College of Business

Contrary to popular belief, credit rating agencies provide more accurate, timely, conservative and informative credit ratings for higher-risk companies—a discovery that calls into question the conventional wisdom that they cater to their clients, according to new research by a team of Penn State researchers in the Smeal College of Business.

Sam Bonsall, Deloitte & Touche Teaching Excellence Professor in Accounting, and Karl Muller, Robert and Sandra Poole Faculty Fellow in Accounting, along with colleagues at Harvard Business School, HEC Paris and Purdue University, recently published a paper detailing these findings in *Management Science*.

"The evidence we provide from our study serves as a counterpunch to prior academic studies that have portrayed the issuer-pay model—under which credit rating agencies are paid by the companies they rate—as more optimistic, slower to downgrade companies and catering to client preferences," Bonsall said. "Instead, agencies are acting responsibly because they have a reputation to maintain."

Corporate bond rating is an important process because ratings indicate to investors the quality and stability of a corporate bond. Bonds with the highest rating—AAA—are considered safer investments with a higher likelihood of the debt being repaid, while those with the lowest rating—C or D, depending on the ratings agency—are considered speculative or "junk" bonds and indicate a riskier investment.

Three agencies worldwide—Moody's Investors Service, S&P Global and Fitch Ratings—conduct at least 95% of the ratings business for corporate bonds, as well as credit ratings for countries, local and state governments and institutions such as universities.

The current issuer-pay model has been used by all three credit rating agencies since the 1970s, and compensation of these three big credit rating agencies is a controversial issue, Bonsall explained. The concern is that credit rating agencies cater to their clients and don't provide early warnings of financial distress to investors.

"If a company wants to issue bonds, it goes to one of the agencies for a credit rating," said Bonsall. "That company pays the agency for the rating. But the issuer-pay model has created this belief that there is a potential, at least, of conflict of interest whereby the agency—because its business is based on selling ratings—may be captured by its clients. If you're the credit rating agency and a bond issuer is paying you a lot of money for a rating, will you give that company a rating it might not be worthy of because you want their business?"

For their study, the researchers gathered ratings data from the financial statements of 537 unique companies from 2003 to 2015. They examined both rating accuracy and relevance using six different models. For each analysis, they examined significant moderators such as the inflection point of the financial crisis of 2007–09.

Using the methodologies employed by Moody's Investors Service, the researchers measured how risky the market perceived the firm was. Then they measured how accurate, timely and informative the credit ratings were for these companies.

"A portion of the ratings are what we call mechanical and don't call for any discretion," Bonsall said. "But then there's a lot of discretion that the agencies use to come up with the final ratings. Agencies make what we call soft adjustments to credit ratings—these soft adjustments are the portion of the rating not linked to verifiable financial performance, and they were our basis for measuring discretion. Do agencies use discretion more judiciously in places where their reputation is more at risk?"

Bonsall and his colleagues focused on higher-risk companies in their study because if a credit rating agency mis-rates a riskier company, the result is more conspicuous. For example, if an agency gave a company a triple A rating and that company went bankrupt a year later, it's likely that the agency was too optimistic and the company didn't deserve that high rating.

After analyzing the ratings data, the researchers found that higher-risk companies that later ended up going bankrupt were much less likely to be mis-rated.

"This finding suggests to us that agencies were indeed scrutinizing and doing a better job for companies that eventually went bankrupt," Bonsall said. "They used their discretion over their methodologies to go beyond what their models say for these companies, assigning their best analysts to their rating teams because these agencies have a reputation to maintain."

While Bonsall acknowledged that the study results don't completely discount the potential for mis-rating under the issuer-pay model, a mitigating factor is that credit agencies depend on maintaining a quality reputation.

"The picture is more nuanced, and this is another side to the story," he said. "Credit rating agencies' reputations are real, and they matter enough to affect their behavior."

More information: Samuel B. Bonsall et al, Do Rating Agencies Behave Defensively for Higher Risk Issuers?, *Management Science* (2022). DOI: 10.1287/mnsc.2022.4537

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