

What Happens When Ratings Shopping is Visible? Evidence from Unaccepted Ratings Disclosure*

Sanjay Kallapur[†]

Hariom Manchiraju[‡]
Rajesh Vijayaraghavan[¶]

Abdul Khizer[§]

1 Introduction

Credit rating agencies (CRAs) play an important role in the functioning of debt markets around the world. However, on several instances CRAs have been criticized for failing to sufficiently forewarn about the impending defaults (e.g., financial crisis of 2008-09), thereby raising questions on the quality of these credit ratings. A long standing discussion in this thought is their issuer-pays business model, and the potential conflicts of interest it opens. CRAs are paid by the firms issuing the securities, which they rate. And the firms directly benefit when they receive high ratings. In further understanding this conflict, regulators and researchers, identify ratings shopping as an important factor affecting the ability of CRAs to provide reliable credit ratings.

Rating shopping refers to the phenomenon where the issuer receives preliminary opinions from multiple CRAs, but purchase and report only the most favorable rating(s), rejecting the others. Therefore, publicly observed ratings reflect a selection bias induced by rating shopping, and often

*Sanjay Kallapur, Abdul Khizer, Hariom Manchiraju are at the Indian School of Business. Rajesh Vijayaraghavan is at the University of British Columbia, Sauder School of Business. The authors acknowledge the financial support of the NSE – NYU Stern Initiative on the Study of Indian Financial Markets for this research work. Rajesh Vijayaraghavan also acknowledges financial support from the Social Sciences and Humanities Research Council of Canada.

[†]Email: sanjay_kallapur@isb.edu

[‡]Email: hariom_manchiraju@isb.edu

[§]Email: abdul_khizer@isb.edu

[¶]Email: rajesh.vijayaraghavan@sauder.ubc.ca

likely to be inflated on average. The ability of issuers to shop around for favorable ratings can also create pressure on CRAs to cater to the demands from clients, and provide them with higher ratings, so as to not miss out on business opportunities, when an issuer goes to a different CRA.

Regulators have long considered the above concerns while regulating CRAs; and attempted to increase transparency of the rating process, and limit conflicts of interest. On one end, an inherent challenge to deter rating shopping is its unobservable nature. But on the other end, any regulation could possibly alter the behavior of firms issuing the securities, and that of the CRAs, resulting in unintended consequences. Therefore, research on understanding regulation of rating process has important implications from regulatory, practitioner, and academic stand point.

2 Research Question

In this paper, we examine the implications when rating shopping becomes observable. To be specific, our research question studies the changes in the issuer, and CRA behavior in an enhanced disclosure regime where investors have information about both the favorable and unfavorable ratings assigned to an issuer. We use a recently enacted regulation in India as a natural experiment to answer our research question. In November 2016, in an attempt to limit conflicts of interest in CRAs in India, the Securities Exchange Board of India (SEBI), enacted a regulation (Circular 2016/119) that requires CRAs to provide details of all ratings that were provided by them, including the ratings rejected and hence not disclosed by the issuers. These details include the name of the issuer, name/type of instrument, size of the issue, rating and outlook assigned, etc., and are available on the website of CRAs. In this paper, we examine whether such enhanced disclosure requirements about rejected ratings by issuers can limit ratings shopping, and thereby reduce ratings inflation.

3 Our Study

To set the discussion, our study first identifies two forms of possible rating shopping behaviour by issuing firms. First, the one identified in the prior section, and focus of prior academic research, is the possibility where issuers seek rating from multiple CRAs, and then strategically decide whether to report it or not. We refer this as strategic reporting. Second, issuers may rely on informal channels, or prior working relationships, to directly select CRAs, in anticipation that they will give them a better rating. We call this shopping behaviour as strategic selection of CRAs.

We then build our analysis on the conjecture that following the SEBI disclosure regulation, rating shopping will be a pointless exercise for the issuers, given that all ratings become visible. It is also likely to relieve the pressure on CRAs to cater. Together, it would decrease ratings shopping in the first form through strategic reporting; thereby improving the overall quality of credit ratings. However, issuing firms could simply adjust their choice of CRAs directly to the ones they know would give them a higher rating, and switch to the second form of rating shopping through strategic selection. For this reason, the pressure on CRAs to cater to inflated ratings is not likely to reduce. Hence enhanced disclosures are unlikely to have any impact on the overall quality of credit ratings.

Our sample to answer the research question comprises of 57,478 unique ratings relating to 12,094 Indian firms from 2014-2019. We consider three years before (pre-period) and after (post-period) the additional SEBI disclosure requirements went into effect. We measure the first form of rating shopping, by strategic reporting, and identify firms to have engaged in rating shopping if it obtains rating from a single CRA rather than multiple CRAs. To measure the second form of rating shopping, we identify firms to have engaged in rating shopping if it obtains rating from smaller rating agencies as opposed to larger, and more reputed rating agencies. The intuition is that smaller CRAs are more likely to pick revenue growth, and appease issuing firms' demands for favorable ratings.

Three measures of ratings inflation are used in the study: 1) by considering the level of ratings, 2) chances of a firm getting investment grade rating. To measure the egregious cases, 3) we

identify based on Type 1 error, reflecting scenarios where rating agencies issue favorable ratings to subsequently defaulting issuers.

4 Results

We first show frequency differences between the pre-period and post-period of the enhanced disclosure regulation. We find that in the pre-period, 85% of all instruments were rated by only one CRA. However, in the post-period 81% of all instruments were rated by single CRA. These statistics show that rating shopping, by strategically reporting ratings, is an extremely widespread phenomenon, and that enhanced disclosure requirement under SEBI Circular 2016/119 leads to a decline in this form of rating shopping. We then find that while 17% of all instruments are rated by smaller CRAs in the pre-period, there is an increase in this frequency to 27% in the post-period. Thus, we find that, while the enhanced rating disclosure reduces rating shopping, through issuers strategically reporting ratings, it increases the rating shopping behavior, in issuers strategically selecting a CRA.

We then perform econometric analysis accounting for other variables like firm level effects, macroeconomic control variables such as GDP growth, risk free rate, and the aggregate defaults to control for overall time trends. In certain econometric models, we also account for rating agency effects. We present a summary of our results in our discussion below. Further discussions are in the working paper version. First, we find that that there is a 5.1% decline in the average tendency of firms to employ a single CRA in the post enhanced disclosure regime. Consistent with the frequency differences discussed above, this suggests a reduction in the rating shopping behavior, in the first form through strategic reporting by firms, in the post-regulation period. We then find that there is a 11.1% increase in the average likelihood of a firm to get ratings from a smaller CRA in the post-regulation period. Consistent with our discussion in the previous section, this finding indicates an increase in firms strategically selecting CRAs, by switching to smaller CRAs for their possible leniency in credit rating standards and incentive to gain market share.

Overall, we find that while the enhanced disclosure requirement for unaccepted ratings leads to a decline in rating shopping in the first form, but it leads to an increase in the second form of shopping behavior in firms strategically selecting a CRA. These results seem to suggest that by engaging more with smaller CRAs, issuing firms are able to comply with the new disclosure requirements, and yet achieve their objective of obtaining favorable ratings.

Next, we study the impact of enhanced ratings disclosure requirements on the extent of ratings inflation using our three measures: ratings level, likelihood of investment grade, and Type 1 error. We find that in the post-disclosure regulation period, the average ratings assigned to firms is approximately 0.66 notches higher. If firms at the lower end of the rating spectrum (i.e., non-investment grade) obtain investment grade rating due to rating shopping, their investment ability increases. Hence, rating shopping is most likely to take place around important thresholds such as investment grade ratings. Consistently, we find that there is a 9.13% increase in propensity of a firm to get an investment grade rating in the post enhanced ratings disclosure regulation period. We also find the incidence of Type 1 error does not vary significantly between pre and post regulation period. Overall, these results indicate an increase in ratings inflation to certain extent in following the enhanced ratings disclosure regulation.

We then examine whether certain firm, or certain CRA characteristics, are associated with higher ratings inflation, in the post period relative to the pre period of the regulation. First, we consider large firms, as these are the firms who have the ability to influence CRAs rating decisions and are known to get higher ratings. CRAs stand to generate more revenue from large firms, relative to small firms, by providing rating as well as non-rating services. In our empirical analysis, we find that large firms, relative to small firms, receive higher ratings by 0.11 notches, have 3.1% greater propensity to get an investment grade rating, and have increased frequency of Type 1 error in the post regulation period, compared to the pre-regulation period. Overall, these results indicate that larger firms get more favorable ratings in the post regulation period possibly because of CRAs catering such demands in expectation of future revenues.

Second, we argue that compared to larger and more established CRAs, smaller CRAs are under greater pressure to increase their revenues. We also posit that larger CRAs have greater need to preserve their reputation under greater regulatory scrutiny. Hence, compared to smaller CRAs, larger CRAs are less likely to cater. Based on these arguments we expect greater inflation in the ratings provided by the smaller CRAs in the post regulation period. We classify the following three rating agencies – India Rating, Brickwork, and Acuite as small CRAs. The large CRAs, hence, are CRISIL, CARE, and ICRA. We find that ratings provided by smaller CRAs in the post regulation period are 0.36 notches higher than the ratings provided by larger CRAs. The probability of getting an investment grade rating in the post regulation period is also higher by 1.7% if such rating is provided by smaller CRA. The frequency of Type 1 error increases by 0.5% in the post regulation period for ratings provided by smaller CRAs, while it does not change for the ratings provided by larger CRAs. Overall, these findings are consistent with our expectations that smaller CRAs are more likely to cater to the demand of favorable ratings by issuing firms.

Finally, we consider whether the rating inflation varies in the post regulation period based on the debt instrument being rated. We classify debt instruments issued by firms as whether they are bank financed vs public debt. Our assumption is that banks are more likely to tolerate (or even encourage) ratings inflation as higher ratings enables them to classify the loan as less risky and thereby improve capital adequacy calculations. We empirically test, and find that ratings provided for non-bank debt instruments in the post regulation period are 0.15 notches lower than the ratings provided for bank debt instruments. The probability of getting an investment grade rating for non-bank debt instruments in the post regulation period is also lower by 2.5%. Further, the frequency of Type 1 error increases by 2.4% in the post regulation period for ratings relating to non-bank debt instruments.

Overall, these results are consistent with our expectations that enhanced ratings disclosure requirements are going to be useful for investors as they can see through the shopping efforts of CRAs and can price the bonds accordingly. As a result, rating shopping is less attractive for issuing

firms in such situations. However, when the end user of the ratings is a bank who has perverse incentives to prefer inflated ratings, enhanced ratings disclosure requirements are unlikely to keep rating shopping and rating inflation under check.

5 Conclusion

Credit rating agencies are important gatekeepers that ensure proper functioning of the debt markets. However, the CRAs business model has been subject of longstanding scrutiny. Much of the concerns are from that the issuer-pay model, where the CRA main revenue in fee income is from the companies that they rate. This conflict creates pressure on the CRAs to provide biased ratings for increased fees, and allows issuers to shop for inflated ratings. But the extent of rating shopping by issuers, and the CRAs ability to cater is unobservable and therefore difficult to empirically determine.

In this paper, we exploit a setting in India, where SEBI enhanced disclosure requirements for CRAs to provide details of ratings that were issued by them, but were rejected by issuers, and hence not disclosed by the issuers. We examine whether such disclosure regulation has an effect on ratings quality, by limiting ratings shopping and thereby reducing ratings inflation.

We provide evidence that rating shopping is a widespread phenomenon in the Indian setting, and that the enhanced disclosure requirements leads to a decline in the rating shopping, in the first form through strategic reporting of ratings. We also find that in the post-regulation period, issuing firms are more likely to approach a smaller CRA, as against a larger CRA; with the intention that smaller CRAs are more likely to cater to the demands of the issuing firms demands for an inflated rating. We interpret this result as an unintended consequence, with an increase in rating shopping in the broader form, where firms strategically selecting CRAs in the post-regulation period. We also find an increase in the incidence of an issuing instrument receiving an investment grade, with the results being stronger to the subsample of larger issuing firms, which suggests that the potential for future business induces CRAs to issue favorable ratings to larger issuers. We finally consider the predictive ability of ratings and document an increase in the incidence of Type 1 error in the

post-regulation period, with the results stronger among larger issuing firms. We find similar results when comparing smaller CRAs relative to large CRAs, and greater ratings inflation in the ratings provided by the smaller CRAs in the post regulation period.

We argue that this research comes at a critical juncture when policy makers across the globe are considering regulations such as enhanced disclosures to avoid another financial crisis. Consequently, our results should be of interest to academics, regulators, and market participants. Overall, we document that a legislation demanding enhanced disclosures may not be the panacea to resolve conflict of interest issues in CRAs.