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The Game Changer: Regulatory Reform and Multiple Credit Ratings

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ABSTRACT

This paper examines the change in the regulatory use of multiple credit ratings after the Dodd-Frank Act (Dodd-Frank). We find that post Dodd-Frank reform firms are less likely to demand a third rating (typically from Fitch) to support their new corporate bond issues. The reduction in the demand for a third rating is more prevalent among firms with ratings near the high yield (HY) - investment grade (IG) boundary, particularly for firms with HY-rated bonds. Third ratings also become less informative post Dodd-Frank, with a much weaker market impact on credit spreads for firms with S&P and Moody's ratings on opposite sides of the HY-IG boundary. We provide new evidence on the effect of Dodd-Frank in curbing corporate borrowers' strategic use of multiple credit ratings and the direct implications for their increased cost of borrowing.

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Background

Credit ratings issued by credit rating agencies (CRAs) are widely used by investors and financial institutions in assessing firms' creditworthiness and determining regulatory capital requirements.

A substantial number of unanticipated credit rating downgrades of corporations and structured securities in 2008 and 2009 have raised concerns about the objectivity and quality of ratings.

In 2010 U.S. Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank):

- Increased legal and regulatory penalties for issuing inaccurate ratings (Section 932 & 933);
- Eliminated all references to the role of credit ratings in regulatory requirements and capital adequacy ratios (Section 939).

We examine the impact of Dodd-Frank on multiple credit ratings.

Motivation

When bonds are rated by two CRAs, the lower rating is used for bond classification.

When bonds are rated by more than two CRAs, the second lowest rating is used to classify this bond (Lehman Brothers index rule change 2005).

Presents firms with a free option to improve their current rating as a third rating (i.e., generally provided by Fitch) cannot worsen the credit quality of the issuer.

However, the regulatory reforms enacted by Dodd-Frank changed the 'credit ratings game'.

Hypotheses

H_1: The prevalence of firms seeking third ratings has declined post-Dodd-Frank.

H_2: The decline in the demand for third ratings is more pronounced for firms with HY ratings near the HY-IG boundary.

H_3: The market reaction to a third rating from Fitch has significantly weakened around the HY-IG boundary.

Data and Methodology

Bond characteristics and credit ratings by Moody's, S&P and Fitch are acquired from the Mergent Fixed Income Securities Database (FISD).

We restrict our sample to senior unsecured newly issued U.S. domestic corporate debentures rated by both Moody's and S&P.

The final sample contains 1,283 bond issues from 2006 to 2015.

Probit model (H_1 and H_2)

- Dependent variable: *Fitch*, an indicator variable equals one if the bond has a Fitch rating, and zero otherwise
- Main variable: *Dodd-Frank*, an indicator variable equals one if firm's bond is issued after Dodd-Frank (i.e., 21 July 2010), and zero otherwise
- Main variable: *Distance*, the absolute distance from the HY-IG boundary

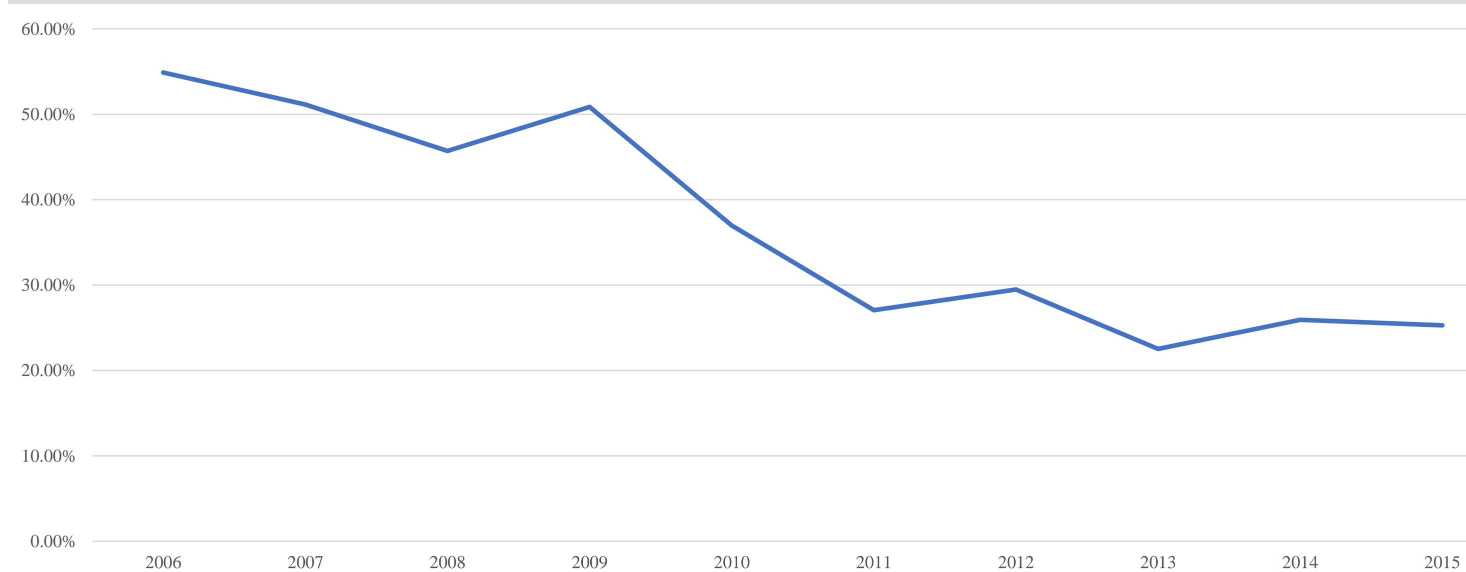

Figure 1 Proportion of Newly Issued Bonds Rated by Fitch

Main Results

Table 5. Fitch Demand: Probit Regressions with Interaction between Distance and Dodd-Frank

VARIABLES	(1) Full Sample Probit	(2) Pre-DFA Probit	(3) Post-DFA Probit
Distance*Dodd-Frank	0.106**		
	(2.022)		
Distance	-0.196***	-0.242***	-0.094***
	(-4.484)	(-5.112)	(-2.597)
Dodd-Frank	-0.491**		
	(-2.071)		
Firm Size	0.200***	0.222**	0.245***
	(3.251)	(2.474)	(3.262)
Intangibles	-0.541	-0.802	-0.465
	(-1.184)	(-1.296)	(-0.885)
Market to Book	-0.052	-0.203	0.032
	(-0.403)	(-1.020)	(0.230)
Leverage	-0.772	-0.608	-0.703
	(-1.517)	(-0.854)	(-1.148)
Profitability	0.048	3.017*	-1.501
	(0.043)	(1.706)	(-1.197)
PPE	0.388	0.120	0.490
	(1.318)	(0.302)	(1.486)
Analyst Coverage	-0.005	0.021	-0.018*
	(-0.577)	(1.558)	(-1.943)
Analyst Forecast Dispersion	0.336	0.328	0.022
	(0.806)	(0.757)	(0.017)
Rating Dispersion	-0.121	-0.071	-0.147
	(-1.528)	(-0.613)	(-1.594)
Constant	-1.245*	-1.892*	-2.251***
	(-1.851)	(-1.945)	(-2.901)
Industry FEs	Yes	Yes	Yes
Year FEs	Yes	Yes	Yes
Observations	1,283	560	723
Pseudo R-squared	0.144	0.214	0.121

Robustness Tests

1. Placebo tests
   - Assigns fictitious event dates
   - A dynamic analysis
2. Other channels (i.e., rule out other explanations)
   - Fitch is more reluctant to inflate due to liability issues?
   - Due to increased efforts in investor screening?

Other Findings

1. HY-rated issues near the boundary had stronger demand for a third rating before Dodd-Frank and experienced a larger reduction in demand after the passage of Dodd-Frank.

2. The reduced regulatory reliance on credit ratings enforced by Dodd-Frank and the removal of the associated regulatory advantage in having higher third ratings has led to a significant reduction in the market impact of Fitch ratings at the investment grade boundary.

Current Work in Progress

Difference-in-differences analysis: **A control group** of rated bonds that are not subject to the U.S. regulatory and litigation environment

- Dodd-Frank applied uniformly to credit ratings issued under the supervision of U.S. securities regulators

Conclusions and Implications

1. Firms are **less likely** to seek a third rating for new corporate bond issues following the implementation of Dodd-Frank. The results are **more pronounced** for bonds with ratings near the HY-IG boundary.

2. Third rating assessments (typically provided by Fitch), have become **less informative** with a diminished impact on credit spreads post Dodd-Frank when firms with current Moody's and S&P ratings are on opposite sides of the HY-IG boundary.

3. Our research provides an important first step in linking the recent regulatory reforms to changes in the 'credit ratings game' and the real effects on firms' economic activities from increased financing costs.