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.

Data and Methodology

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

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 issuances from 2006 to 2015.

Probit model (H1, and H2):
- Dependent variable: If, 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-IIG boundary.

In 2014 and 2015, the University of Sydney

Hypotheses

H1. The prevalence of firms seeking third ratings has declined post-Dodd-Frank.
H2. The decline in the demand for third ratings is more pronounced for firms with HY ratings near the HY-IIG boundary.
H3. The market reaction to a third rating from Fitch has significantly weakened around the HY-IIG boundary.

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-IIG 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-IIG 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.