Multiple Credit Ratings, Cost of Debt and Self-Selection

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Abstract: In a world where firms pay for credit ratings and (because of regulatory requirements) where some investors must pay attention to the ratings of some specified set of raters, it may well be in the interests of a firm to seek a third ‘optional’ rating, beyond the standard ‘mandatory’ two ratings from Moody’s and Standard and Poor’s. The firm may get a better rating from the third major rater Fitch, which could save substantially on future debt issuance costs. In this paper I specify and estimate a structural self-selection model of the demand for optional credit ratings derived from their expected reduction effect on borrowing cost compared with the optional ratings’ cost. Attention is focused on specifying the role of expected cost of debt savings in the derived demand for optional ratings; these are found to be empirically important determinants of the decision to request Fitch ratings.

Keywords: credit ratings, default risk, selection bias

1. INTRODUCTION

The US rating market is highly concentrated and can be characterized by a ‘two-rating norm’, i.e., to access a broad investor pool, issuers are implicitly required to obtain ratings from both major credit rating agencies, Moody’s and Standard and Poor’s (‘S&P’s’). The two-rating norm and their earned reputation in financial markets protects these two agencies to some degree against competition from ‘third’, smaller agencies like FitchRatings (‘Fitch’) and makes them less susceptible to issuer pressure for upwardly biased risk assessments. However, given the established debt certification value of ratings from Moody’s and S&P’s, debate exists about the economic justification

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1 To reflect the two-rating norm and to follow the literature (Cantor and Packer, 1997), I will call Moody’s and S&P’s a ‘mandatory’ agency (or one that assigns and publishes ratings on all issuers) and Fitch an ‘optional’ or ‘third’ agency (or one that only assigns and publishes upon request of the issuer).