Rating agencies and the role of rating publication rights

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ABSTRACT

While credit rating agencies disclose all public ratings as a matter of policy, a firm can choose whether to make a so-called private rating public or to keep it confidential. This paper analyzes the economic role of such rating publication rights. In particular, the paper tries to answer the following two questions: (1) If firms have scope to disclose agency ratings at their own discretion, can they use this discretion strategically and conceal low-quality ratings? and (2), if this is the case, what are the economic implications for rated firms, unrated firms and the rating agency, resulting from strategically motivated selective rating disclosures? Using a theoretical model, it is shown that an equilibrium with partial nondisclosure of low-quality ratings can emerge whenever investors cannot be sure whether rating nondisclosure is due to the firm being not rated, or due to the rating’s adverse content. Moreover, since from an investors’ perspective, strategically acting rated firms and unrated firms are pooled, unrated firms’ debt is always under-valued (compared to a situation in which investors know that the firm is not rated), and the debt of firms concealing their rating is always over-valued.

1. Introduction

Whereas credit rating agencies (CRAs) have always been subject to periodic complaints and criticism, the recent wave of corporate scandals has led many to call their contribution to market efficiency into question. In light of such criticism, CRAs have come under the attention of several policy-makers and regulators, like the International Organization of Securities Commissions (IOSCO), the Securities and Exchange Commission (SEC), and the European Commission. In December 2004, the IOSCO published a “code of conduct for credit rating agencies” that sets out a series of measures that agencies should incorporate into their own codes of conduct. According to the IOSCO, the implementation of the code’s principles should be left to market pressures. The Code enjoins CRAs to strive for transparency with respect to their ratings and rating processes. Thus, it requires that the ratings decisions, or the subsequent decision to discontinue a rating, be dispensed in a timely manner, on a non-selective basis, and free of charge. In particular, sub-principle 3.2 (IOSCO, 2004) states that

Except for “private ratings” provided only to the issuer, the CRA should disclose to the public, on a non-selective basis and free of charge, any rating regarding publicly issued securities, or public issuers themselves, as well as any subsequent decisions to discontinue such a rating, if the rating action is based in whole or in part on material non-public information.

This implies that a CRA can give explicit publication or disclosure rights to issuers for private ratings, without violating the code’s principles. All three major international CRAs follow this practice of differentiating public from private ratings. For example, in their description of the rating process, Standard & Poor’s (S&P’s) explains the difference between public and private ratings as follows (S&P’s, 2006a, p. 10):1 “In the US, S&P’s assigns and publishes its ratings irrespective of issuer request, if the financing is a public deal. In the case of private transactions, the company has publication rights. In most markets outside the US, ratings are assigned only on

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1 Similarly, Fitch prepares private ratings “for entities with no publicly traded debt, or where the rating is required for internal benchmarking or regulatory purposes. These ratings are generally provided directly to the rated entity, which is then responsible for ensuring that any party to whom it discloses the private rating is updated when any change in the rating occurs. Private ratings undergo the same analysis, committee process and surveillance as published ratings.” (Fitch, 2006, pp. 5–6). Moody’s does not provide a clear description of what constitutes a public and a private rating, but, instead, simply states: “Moody’s retains complete editorial control over the content of its credit ratings, credit opinions, commentary, and all related publications. […] Moody’s editorial control includes its right to decide whether, and when, to issue a credit rating or publish any information or commentary, except in those rare instances where the public disclosure of a credit rating has been contractually limited. […] Upon the request of an issuer, and at Moody’s sole discretion, Moody’s may agree to keep a credit rating confidential.” (Moody’s, 2006, p. 4 and 9).