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Conflicts of Interest and the Provision of Consulting Services by Rating Agencies: Indian Evidence

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"Separate ratings from consulting – just as accountants were compromised by their consulting assignments, ratings firms have similar issues." (Letter from Sean J. Egan and W. Bruce Jones, Egan-Jones Ratings Company, to Jonathan G. Katz, Secretary, SEC, November 10, 2002).

1. Introduction

Credit rating agencies are important information providers in credit markets, and the quality of the ratings they produce is important to the functioning of the financial system. Flawed ratings were critical to the recent financial crisis, when large losses on securities that had received overly optimistic ratings at issue contributed to destabilizing the financial system. Aggressive competition for revenue may have contributed to deteriorating credit standards. For example, rating agencies had made recommendations to securitization arrangers (e.g. banks) on how to structure financial products to receive a desired credit rating and, subsequently, issued a rating on the same products.

Fundamentally, the concerns with the ratings system are related to the conflict of interest generated by the rating agencies' "issuer-pays" business model. Rating agencies are mainly paid by the companies whose securities they rate. These companies benefit from favorable (high) ratings on them or their securities. Therefore, the compensation arrangement leads to a conflict of interest between producers of ratings (the agencies) and users of ratings (such as investors). The heart of the problem is the flow of money from issuers to raters.

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The commercial ties between issuers and raters have two components: (i) rating agencies perform rating services, usually charging according to a standardized price list, and (ii) rating agencies also perform a variety of non-rating services (we use the term “consulting services” interchangeably). One example of consulting services is “ratings assessment services”, which encompass pre-rating analyses as well as assessments of the potential effect of a hypothetical transaction, such as a merger, spin-off or share repurchase on an issuer. Other non-rating services offered to issuers include risk management consulting, debt restructuring consulting, regulatory advice and monitoring services.

2. Our Study

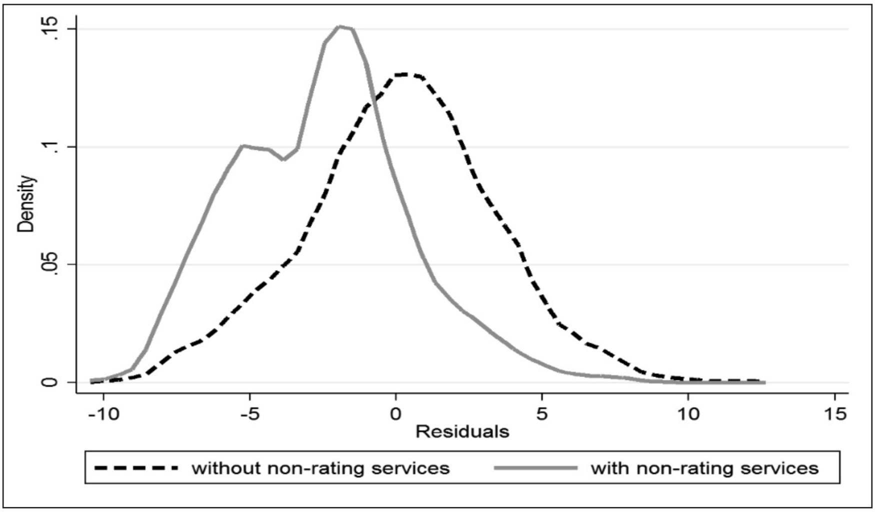
We investigate the relationship between debt issuing companies and rating agencies and examine whether these commercial ties are correlated with differential ratings treatment. We exploit a recent change in regulation in India (the circular “CIR/MIRSD/CRA/6/2010” issued by the Securities and Exchange Board of India (SEBI) in 2010), which required Indian rating agencies to disclose important details about their compensation arrangements with issuers of debt securities. These disclosures permit us to determine whether a given issuer pays a given rating agency for consulting services, and if so, the amount of fees paid. Our sample period is 2010-2015.

3. Results

First, we find that those rating agencies that also perform consulting services for a debt issuing company, on average, rate that company higher (that is, issue ratings designating lower default risk) as compared to other rating agencies who do not provide any consulting services to the issuing company. Figure 1 illustrates this result graphically. This figure plots the distribution of ratings for issuers that obtain non-rating services and those that do not, after accounting for industry effects (by subtracting from an issuer’s rating the average rating of firms in the issuer’s industry). The figure shows that issuers that generate non-rating revenue for the rating agency obtain a rating that is on average about three notches better (the alphanumerical ratings are translated into numerical ratings in our analysis, with smaller numbers designating lower default risk).

Figure 1: Ratings of Firms with and without Non-rating Services

This figure shows the distribution of issuer ratings for firms that obtain non-rating services and those that do not, after accounting for differences due to industry effects.



The difference in ratings between debt issuing firms that hire a rater for non-rating services and those that do not as documented in Figure 1 is likely to be driven by a number of different factors, some of which may be unobservable. As a consequence, the simple correlation between the rating of an issuer and the provision of consulting services to that firm may not necessarily (only) reflect biased ratings.[2] In order to narrow down the set of possible explanations for the difference in ratings, in our econometric analysis, we focus on firms that use multiple rating agencies and pay for consulting services from some of these agencies, but not others. This permits us to compare the rating that a given firm receives in a given year from raters with whom the firm has a consulting relationship to the rating received from raters that do not provide such services to the firm in that year. This approach helps rule out a number of alternative explanations centered on the fact that firms that hire raters for non-rating services may be fundamentally different from firms that do not. An example of an

2 For example, firms with bigger balance sheets (more assets) tend to have lower default risk, on average. At the same time, such firms may have more complex capital structures, thus making them more likely to pay raters for consulting services (e.g., for credit risk management and debt management). Thus, in this example, the correlation between ratings and provision of consulting services may be spurious, as it is driven by firm size.

alternative explanation of why issuers that hire raters for non-rating services obtain a higher rating than those that do not is that, the former may be larger firms with better credit fundamentals than the latter.

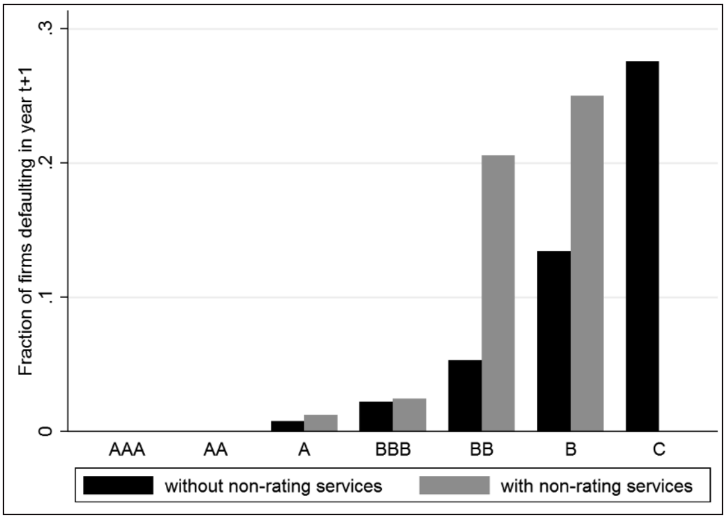
In our tests, which can be found in our working paper, we find that rating agencies rate securities issued by companies that also hire them for non-rating services 0.3 notches higher than agencies that are not paid for such services by the issuer. While this illustrates that controlling for selection bias is important as it accounts for a large part of the difference in ratings between firms that obtain consulting services and those that do not, the results also suggest that an economically important effect of the provision of consulting on ratings remains.

Next, we examine the amount paid for consulting. We find that issuers tend to obtain higher ratings the more (non-rating) revenue they generate for an agency. The strong apparent role for non-rating revenues may reflect that there may be more leeway in the pricing of non-rating services (compared to perhaps more fixed payment schedules for ratings services). That would imply that using non-rating services is a more direct way of transferring rents to a rating agency, and thus the key variable for predicting biased ratings.

Finally, we study defaults. If higher ratings assigned by agencies to those issuers that pay for non-rating services are warranted, then default frequencies should be similar for firms within a given rating category, whether or not these firms have a consulting relationship with the rating agency. If such issuers instead are treated more favorably, their ex-post default frequency would be higher than for other issuers with the same rating. In Figure 2, we graphically examine the relationship between ratings, the payment for non-rating services, and defaults. We plot the one-year default rate on the vertical axis against broad rating categories on the horizontal axis; within each rating category, we now also separately report average one-year default rates for issuers that obtain non-rating services and for issuers that do not pay for such services. While there were no defaults in the categories AAA and AA during our sample period, the average one-year default rate across all rating categories was 3.8% during our sample period (2010-2015). The figure shows that within rating categories, default rates are higher for firms that pay for non-rating services. In tests detailed in the paper, we confirm that these differences in defaults between firms that pay for consulting services and those that do not are jointly statistically significant, and that these effects are increasing in the amount paid for consulting. This is our third finding: default rates are too high for non-rating services to be a sign (or a cause) of lower credit risk. The fact that issuers that obtain non-rating services have higher ratings but also higher default rates is most consistent with a conflict of interest interpretation.

Figure 2: Ratings and Default Rates: The Role of Non-Rating Revenue

The figure shows one-year default rates by rating category; for each rating category, default rates are separately shown for firms that pay for non-rating services and those that do not.



4. Discussion

Our findings point to the importance of understanding the entire commercial relationship between raters and rated firms (issuers). Given that non-ratings activities are important, this relationship likely cannot be understood without looking at the payments for such services as well. For example, Moody's reported in 2014 that Moody's Investor Services generated $2.4 billion in ratings-related revenues, while the group's other division, Moody's Analytics, generated $1.1 billion from selling services for "measuring and managing risk". Moody's non-rating services are quite profitable, with an operating margin of 20% in 2014. Non-rating profits grew 28% from 2013 to 2014, compared to 15% profit growth in the ratings division. Similarly, aside from rating debt instruments, Indian rating agencies engage in a large variety of consulting activities that account for a significant part of their revenue. Among others, Indian agencies provide some or all of the following non-rating services: (i) "grading" of mutual funds, real estate projects, IPOs, hospitals, business schools and local government bodies; (ii) risk management services; (iii) industry analysis; (iv) business and marketing analytics; (v) equity research; (vi) business process IT services; (vii) management consulting. The fraction of total revenue generated by rating services decreased from 63% in fiscal year 2010-11 to 54% in fiscal year 2013-14 for ICRA Group (one of the largest rating agencies in India). In the case of CRISIL (the largest Indian rating agency by revenue), the fraction of total revenue generated by rating services decreased from 40% in fiscal 2010 to 36% in fiscal 2013. These figures show that non-rating revenue accounts for a major and increasing part of Indian rating agencies' revenues.

Regulators worldwide have expressed concerns with regard to potential conflicts of interest that may occur when raters provide consulting services to issuers they rate. According to the SEC (Securities Exchange Commission, 2003), "in the case of ratings assessment services, there are concerns that, to the extent a rating agency has already 'promised' a certain rating to an issuer's hypothetical scenario, pressure to match the actual rating to the promised rating is likely to be forceful, even if the ultimate analysis otherwise might not have supported the rating." More generally, a recent report to Congress by the SEC described the potential conflicts of interest involving non-rating services as follows: "[…] an NRSRO (Nationally Recognized Statistical Rating Organization) might issue a more favorable than warranted credit rating to an issuer or other party in order to obtain ancillary services business from them, or an issuer that purchases a large amount of ancillary services could pressure the NRSRO to issue a more favorable than warranted rating on that issuer."

5. Conclusions

The conflict of interest stemming from the provision of non-rating services is similar in nature to that of accounting firms offering non-audit services to their audit clients. However, in contrast to accounting firms, rating agencies have not been subject to significant regulatory restrictions with regard to the provision of consulting services. Rating agencies have firewalls separating the ratings business from the non-ratings business. It is not clear that such organizational measures are effective at containing agency conflicts. For example, in the case of the ratings assessment services, the same ratings analysts who generate ratings also tend to carry out the ancillary assessments.

In terms of policy implications, our empirical findings imply that there may be scope to better manage the inherent conflict of interest that partially compromises the quality of third party ratings, and handle the particular complication posed by raters offering consulting services to ratings clients. Mandating issuer disclosure of non-rating services purchased, as well as information on rating fees and other payments to rating agencies could help mitigate these agency problems. A similar regulatory requirement exists for accounting firms, which have to disclose their accounting and consulting fees (separately) in 10-K statements to the SEC. Alternatively, rating agencies could be asked to disclose detailed fees and other revenues for individual issuers.