

Reputation capital

How bond investors use bond ratings, and the role that ratings play in the market **Interviewed by Meredith McKenzie**

Bond ratings play a key role in the financial market, as they have a major impact on bond yields, and hence, the borrowing cost of issuing firms.

Many investors rely on bond ratings to gauge the default risks of bond issues. However, much has changed in the recent financial crisis. Rating agencies have been under fire for overrating many mortgage-backed securities in the years leading to the recession, and questions have been raised about the potential conflicts of interest as rating agencies are paid by issuing firms.

A factor that may mitigate the potential conflict of interest is rating agencies' concern for their long-term reputation. Indeed, studies show that reputation matters.

"Investors pay less attention to an agency that typically gives higher ratings and place more weight on ratings from the more stringent agency," says Lei Zhou, assistant professor of finance at the Northern Illinois University College of Business. "So the rating agencies have to determine whether a solid reputation or a quick profit is more important to their business in the long run."

Smart Business spoke with Zhou about the role ratings play in the financial market and how rating agencies can be regulated to mitigate the potential conflict of interest.

What role do bond ratings play in the financial market?

Receiving a bond rating from the two major agencies — Moody's Investors Service and Standard & Poor's — is one of the first things firms do when trying to sell bonds in the public market. These ratings help determine the borrowing cost to a firm.

Ratings range from AAA — extremely safe — to CCC — extremely risky. The agencies will analyze an issuing firm's fundamentals and determine the firm's rating or their opinion on the firm's default risk.

Ratings are also important to bond investors, especially less sophisticated, smaller investors who depend on bond ratings to determine the riskiness of a bond issue.

Why are rating agencies blamed for the recent financial crisis?

Agencies gave out a lot of AAA ratings between 2004 and 2006 to mortgage-



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backed securities that had very risky underlying subprime mortgage loans. As investors believed these securities were safe, they invested in a lot of them and, consequently, increased significantly the available credit in the housing market. This partly led to the housing bubble.

By 2007, many of the subprime mortgage loans began to default and, as a response, rating agencies dramatically downgraded massive amounts of mortgage-backed securities. As a result, many investors lost a lot of money and their confidence in the financial system, directly contributing to the financial crisis.

Why is there a conflict of interest?

As rating agencies are paid by issuing firms, they may give higher ratings as a way to gain business and boost profits. For example, if issuers receive a lower rating based on their true default risk, they may be unhappy and turn to another agency for a better rating or engage in 'rating-shopping.' Rating agencies might lose business if they do not give higher ratings, which creates the conflict of interest.

However, in the long run, investors will not trust an agency if it consistently inflates ratings. Indeed, my study finds that

reputation matters and bond investors place more weight on the ratings from the more stringent agency.

The study highlights the importance for the rating agencies to protect their reputational capital. Such concerns for long-term reputation capital may mitigate the potential problem of conflict of interest.

How can agencies be regulated to avoid this conflict?

This can be tricky, and the government is very cautious about how to regulate the rating agencies. One concern is that further regulation may create a false impression of government endorsement of rating agencies.

Before new regulations are considered, there needs to be a separation of the private and regulatory roles of agencies. Right now, ratings are used by regulatory agencies, like the SEC, in their regulation of financial institutions. Regulatory agencies should not delegate their duties to private rating agencies.

Effective regulation should require rating agencies to disclose as much information as possible, including ratings methodology, assumptions and fees charged. Investors can then determine if the agency is doing a good job and whether the methodologies and assumptions are valid.

In addition, there needs to be an independent, third-party review done periodically to compare the performance of multiple rating agencies. Competition in the rating industry also needs to be increased.

How can investors use ratings and their own research to make the best decisions?

After the collapse of Enron, investors have started to lose confidence in the ratings and are paying more attention to a company's fundamentals and are doing more of their own research to gauge the default risk above and beyond the bond rating.

It's bad for rating agencies, because investors are discounting what they're saying, but it's good for the financial market because more information will be generated and priced. Ratings should only be one piece of information. <<

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