Summary of the paper: Motivation

- This paper highlights the mechanism behind the conflicts of interest inherent in the "issuer-pays model" in the credit rating industry.

- Apart from rating services, credit rating agencies (CRA) also provide other fee-based services (non-rating revenue) such as:
  - management consulting,
  - business analytics,
  - equity research etc. to bond issuers.

- To maximize revenue, competing CRAs can provide upwardly biased ratings to issuers (clients) that are major contributors to non-rating revenue.

- Data on fees and contracts between CRAs and their clients is not public. So, no direct evidence that utilizes payments to CRAs by issuers.

- This paper attempts to fill this important gap in the literature

Summary of the paper: Methodology

- Paper exploits an institutional feature in India,
  - where CRAs have to disclose details about their compensation arrangements with debt issuers (post a regulation change in 2010).
- Methodology: use of differences in ratings across rating agencies for the same (issuers, year)
  - Clever!

Summary of the paper: Overview of results

❑ Authors report three main findings –

- (i) Rating agencies that receive non-rating revenue from an issuer provide on average 3-notch higher ratings to that issuer;
- (ii) issuers tend to get better ratings (relative to the average rating the issuer has) from raters whom they pay more.
- (iii) Such relatively higher ratings issued by a CRA correlate positively with the probability of default in the next 12 months

  ❖ A powerful result that rules out alternative interpretations

My assessment

- The paper examines a very important issue and the potential contribution is very clearly laid out.
- Clever use of difference in ratings given by different agencies.
- Have provided two rounds of comments, which authors have already incorporated
- Focus my discussion on sharpening the interpretation of the results.
- Overall, I like the paper! Urge you all to read it carefully.

An efficient equilibrium

- Poor quality firms seek out a CRA that is willing to "hand hold"
  - Of course, for a fee (=non-rating revenue)
- The process of "hand holding" uncovers positive but firm-year specific information that leads to a better rating
  - Because the information is firm-year specific, another CRA that has not provided hand-holding services will assign a worse rating.
  - Difference higher when "hand holding" is more intensive because firm-specific information uncovered is greater.
- The hand-holding activity is indeed valuable. So future default probability decreases.
  - Decreases more when the hand-holding is more intensive.

An efficient equilibrium (2)

- All the results would be obtained in this equilibrium
  - CRAs with non-rating services provide a better rating
  - Higher the non-rating service revenue, better the rating
  - Default probabilities lower when rating is provided by a CRA that "hand holds" the firm
- First two predictions would be obtained even with (issuer, year) fixed effects and/or (CRA, year) fixed effects in the efficient equilibrium
- The third prediction really sharpens the interpretation because the efficient equilibrium delivers an opposite prediction

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Another efficient equilibrium

- Risk-assessment & risk-management are complementary activities
  - Information gained during risk-assessment enhances the efficiency of risk-management and vice-versa
- Incentives for risk-management enhance the quality of risk-assessment
  - Incentives for risk-management increase effort in risk-management => risk-assessment becomes more efficient
  - So greater effort in risk-assessment
- Non-rating services therefore lead to more accurate ratings.
- Again the positive correlation of default with non-rating services helps with the interpretation.
- The results cannot be explained by either (efficient) equilibrium.

What if risk-assessment & risk-management are substitutes?

❑ Incentives for risk-management reduce the quality of risk-assessment

- Incentives for risk-management increase effort in risk-management
- Given substitutes, risk-assessment becomes less efficient
- So lower effort in risk-assessment
- Inaccurate ratings reflected in higher default

❑ Non-rating services therefore lead to less accurate ratings

❑ In this case, the results are <u>not an outcome of agency problems</u> but an outcome of the <u>nature of the production function</u> for risk-assessment and risk-management

Can check this efficient interpretation

- Interpretation depends upon substitutability or complementarity of risk assessment and risk management
  - If complementary, results are definitely an outcome of agency problems/ conflicts of interest
- Can check this:
  - After conditioning on size, rating revenue and non-rating revenue positively (negatively) correlated if complements (substitutes)
- Showing that risk assessment and risk management are complements and yet the results are obtained sharpens the policy implications.

Policy implications depend upon the interpretation

- If the results are due to substitutability of risk-assessment and risk-management, then individual CRAs can make their portfolio decisions
- If the results are due to agency problems/ conflicts of interest, need for regulation to limit non-rating services

In sum

- Paper examines an important question. Potential nice contribution
- Urge authors to sharpen the interpretation
- Enjoyed the paper. Look forward to the revision!

ISB