Firm Value and the Costs of Rating-Contingent Regulation: Evidence from the Establishment of ‘Investment Grade’

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Valuing Rating-Contingent Regs

- First instance of federal rating-contingent investment restrictions (“investment grade” by CRAs)—1936 by OCC
- Using diff-in-diff negative cumulative returns for users of speculative bonds
- Potentially unexpected and first time
- A way to evaluate the cost of rating contingent regulation
- Advantage—world not as complicated (?)
- Nice links to capital structure theory

Clarifications

- 1936 simpler(?)—but less about it known
- How were ratings used by (non-federal) governments, others? What was import?
- Was this the first role that ratings played? Was introduction a “surprise,” exogenous?
- Rating-contingent regulation is costly; what does that mean—why not repeal? (We sort of did—under Dodd-Frank!)
- Can we compare bond just below and just above threshold?—partial pooling equilibrium and clustering

Ratings Matter

- Even absent the regulatory channel, the informational consequences of ratings influences the structure of asset prices and therefore, both real investment and financing decisions
- Ratings matter through contractual triggers and even feedback effects
- Various events--Moody’s Reconstitution, Lehman Rating Redefinition and sovereign bound highlight real effects of ratings—emphasize more

Why Ratings?

- Public signals as efficient response to scale economies in information production
  - Public signals can discourage due diligence
  - --Value, capital structure, project choice & reg.
- Source of systemic risk
  - Systematic (aggregate) risks
  - Not enough heterogeneity in views, still underlying common view (potentially wrong)
  - Hardwired into regulation
  - Hence reduced regulatory reliance (LeMieux)

Regulatory Reliance

- Capital standards, suitability (insurance companies, collateral--regulatory eligibility)
- Dodd-Frank pulled back (but not state, local and to a degree global)
- Suggests importance of uniformity in standards across spaces—corporates, munis and mortgages; rating agencies
- Regulatory reliance as anti-competitive
- Pulling back *partially* promotes diverse signals rather than “common view”

NRSROs & Regulatory Reliance

- Does pulling back on regulatory reliance reflect hostility to NRSROs?
  - Some critics of NRSROs regarded voting for LeMieux as an anti-NRSRO vote.
  - Yet some NRSROs supported LeMieux
- SEC also tried to pull back on regulatory reliance in 2008 to min gov't franchise & encourage competition, but opposed, e.g., mutual funds like 'safe harbor' to manage liability (moot after crisis/Dodd-Frank)

What Did Dodd-Frank Do?

- Pull back on “regulatory reliance” to reduce systemic risk
  - Replacing with verbal descriptions
- Supervise closely CRAs/registration
- Supervision vs. reduced reliance as substitutes! (Consistency of response)
  - Regulatory design not optimal, before or after
- Attempt to create prospectus liability
- Franken Amendment study

Diverse Views on Regulating

- 99 Senators voted on both LeMieux and also Franken Amendment (push on limiting “shopping” by encouraging rating assignment board)
- Both were adopted, yet only 30 Senators supported both (64 voted for Franken and 61 then voted for LeMieux after Franken adopted); just four opposed both
- Supervision vs. LeMieux: Substitutes
- Does regulatory reliance mitigate agency?

References

- Sangiorgi, F. and C. Spatt, 2017, “Economics of Credit Rating Agencies,” monograph, *Foundations and Trends in Finance*.

- Sangiorgi, F. and C. Spatt, 2017, “Opacity, Credit Rating Shopping, and Bias,” *Management Science*.