THE EVENT OF CREDIT RATING WITHDRAWAL: WHAT HAPPENED? WHAT FOLLORS?

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The event of Credit Rating Withdrawal: What happened? What follow?

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Credit ratings are independent opinions on borrowers' credit risk issued by credit rating agencies (CRAs). Most agencies, including Moody's and Standard & Poor's (S&P), operate under the issuer-paid model whereby borrowers solicit a rating and pay the credit rating agencies for it. While numerous studies focus on the increase or decrease of the level of credit ratings (i.e. upgrades and downgrades) of sovereigns and companies, little attention has been devoted to credit rating withdrawal which is thus the focus of this article.

The first contribution is to better understand why the event of credit rating withdrawal happens. Thus, we first hand-collect the reasons of the withdrawals. Next, we investigate which types of firms are more likely to be involved. The second contribution of this work is to show whether firms' features change after the rating withdrawal. Taken together the results offer important evidence and implication for investors and regulators.

1. A first look at the withdrawal of ratings

What is a credit rating withdrawal? "Moody's Investors Service (MIS)[2] withdraws its rating when it no longer rates an entity, debt or financial obligation, debt issuance program, preferred share or other financial instrument for which it previously assigned a rating".

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[2] Moody's Investor Service, 2011. Policy for withdrawal of credit rating.

Looking at the statistics of the European Securities and Market Authority (ESMA), we see that credit rating withdrawals are far from being rare events. As shown in graph 1, from 2004 to 2011, among the 2824 ratings issued by Moody's for non-financial institutions, 16% of them have involved downgrades while 61% of them have been withdrawn. Nevertheless, the academic literature and press news have overlooked the event of rating withdrawals.

Why and when do credit rating withdrawals happen? The specific reasons for the withdrawal of ratings are stored neither by Moody's nor by regulators before 2010. We implement a manual search on the website of Moody's announcements in order to collect the reasons for the withdrawals. According to the findings, we classify the reasons for the withdrawals implemented to stop rating the firm in four main categories. First: incorrect, inadequate, or insufficient information cause difficulties in assessing the rated entities' creditworthiness. Second: due to bankruptcy, liquidation or debt restructuring it may no longer be useful to rate the entity. Third: the reorganization of issuers, such as a merger or acquisition, can also cause the cancellation of ratings. The fourth important category is the withdrawal of ratings due to business reasons. The group of withdrawals for business reasons involves the cancellation due to a request of the firms for reasons not specified in the announcements but that are unrelated to all the above categories.

Lastly, by reading Moody's announcements we identify a group of withdrawals that refers to a particular Moody's policy implemented for firms which belong to a group. The aim of the policy change is to withdraw the issuer rating to consolidate the rating information at the level of the business group. Looking at the European market between 2001 and 2010, Table 1 shows the reasons for the withdrawals that were hand-collected from the Moody's website. For each category we compute the number of days between the withdrawals and the previous rating change. At first glance, the distance between the withdrawal and the previous rating announcement is quite large; moreover, the distance is similar among the different reasons. This leads us to reasonably conclude that there is no relationship between the reason for withdrawals and the previous rating announcement.

2. The determinants of rating withdrawals

A priori, which types of firms are more likely to be involved in rating withdrawal is unclear. One may think that big firms with established reputation are the most likely candidate. Indeed, these firms should be able to decrease the disclosure of information without suffering a cost. The alternative hypothesis is that the probability of withdrawal is higher for risky and small firms with low growth opportunities. Several reasons may support this hypothesis. First, small and risky firms are likely to have high distress costs and to choose lower level of leverage, reducing the benefit of rating information. Similarly, firms with low growth opportunity may decrease their demand for debt with a consequent reduction in rating information needed. In addition, one should consider that also the agency may choose to withdraw a rating. This may happen for example when the rating agencies do not have enough information to assign the rating. We investigate these hypotheses in the following way: we compare a sample of listed European corporate companies that lost their Moody's rating in the period 2004 to 2010 with a similar group of firms which was not involved in the withdrawal. Results show that firms tend to be involved in the withdrawal of ratings when they are smaller and present more risks. The change in the asset size (asset growth), in the year prior to the event, does not influence the likelihood of suffering a withdrawal. Results indicate that firms with a low liquidity ratio and a low market to book value are more likely to be involved in the rating event. Firms with low growth opportunity may be less interested in the certification function and thus they are more likely to cancel their rating. The likelihood of a rating withdrawal is positively related to the level of bank and non-bank debt. This confirms that the utility of the rating information may decrease when the leverage is already high. Riskier firms with more volatile market price are more likely to withdraw the ratings. Broadly, the result is that the withdrawal of the rating involves firms with low investment demand and the smallest and riskiest issuers of each rating class.

3. The effect of the credit rating withdrawal

We employ several empirical analyses to investigate the impact of the credit rating withdrawal on corporate policies and issuer market price. This means that we test whether the withdrawal, by decreasing the available information, trigger higher cost of capital and more difficulties for the issuer in collecting debt. The surprising result is that regardless of the decrease in information, the cancelation of one rating can result in a benefit for the issuer. Indeed, the reaction depends on the remaining outstanding rating information. When the withdrawn rating is lower than other ratings outstanding (e.g. by competing agencies), the market reacts positively. Indeed, the cancellation of the more conservative ratings which leaves the issuer with an outstanding higher rating, causes an increase in debt from uninformed lenders, which may consider as cheapest debts. Similarly, the removal of the conservative rating trigger a reduction in the cost of capital.

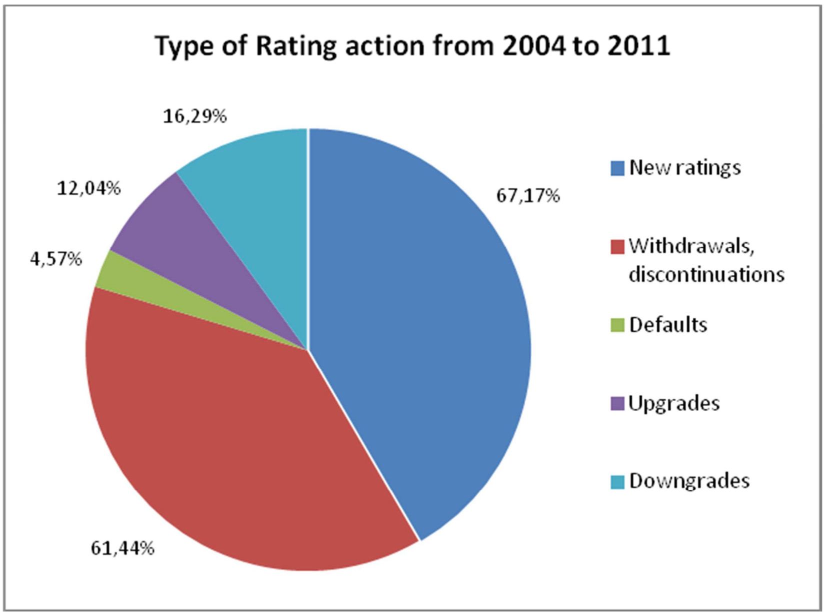
4. Credit rating regulation and credit rating withdrawals

Regulators use credit ratings to establish legal investment standards and bank capital requirements. For example, institutional investors (such as mutual funds and life insurers) are constrained to a minimum rating for the securities in which they invest. The most significant distinction made by regulators is whether or not the issuer is classified with Investment Grade (IG) or Speculative Grade (SG) status. This classification depends on the number and the level of published ratings. For example, if an issue has two ratings, only the worst rating is considered or, in case of three ratings, the average is considered (see, for example, Basel II accord and Bongaerts et al., 2012). We find that the market reacts positively when the withdrawal of the SG rating by Moody's leaves the issuer classified as IG by S&P, suggesting that the rating regulatory certification plays a role in the market.

Conclusion and Implications

The analysis of the event of credit rating withdrawals is twofold. First, it is the first to provide a detailed description of the credit rating withdrawal, and to collect a new set of statistics. Second, it shows that firms may benefit when they stop to pay for a conservative rating. These results emphasize the potential incentive to engage in *ratings shopping*, which means that firms are induced to selectively disclose ratings. These results should be of strong interest for the regulator.

Graph 1. Rating action by Moody's. The graph shows the percentage of rating action types by Moody's. It includes actions from 2004 to 2011 for US and European non-financial institutions. The percentages are computed over the number of outstanding ratings by Moody's in January 2004, which is 2824. The source is the central repository (CEREP) set up by the European Securities and Market Authority for publishing rating activity statistics. Discontinuity refers to a change in the rating methodology, such as the policy change we analyze.



***,**,*=1%, 5%, 10%

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