



Swedish House of Finance

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Financial Research

Rating Friends: The effect of Personal Connections on Credit Ratings

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QUESTION

- How do personal connections of directors of firms and rating agencies matter for credit ratings?
- Important and interesting question
 - Are connections socially desirable as they may improve rating quality? (e.g., less noise)
 - How much discretion / impact to individual persons have on rating?

EFFECT EX-ANTE UNCLEAR

- No effect
- No effect on average rating
 - but ratings become more informative
- Positive effect
 - CRAs favor connected firms
- Negative effect
 - CRAs are more conservative when connected
 - Litigation risk?

FINDING

- Companies that are connected to rating agencies have higher credit ratings (one notch on average)
 - Past connections appear to be more important than current connections
 - Army connections appear to be more important than professional connections

COMMENTS

- Interpretation of results is difficult
 - Not/Having links to CRA is not exogenous
- E.g., selection on firm side
 - Mostly bad companies hire connected directors
 - “last-resort”
 - OLS estimate is downwards biased
 - Mostly good firms are connected
 - E.g., can attract people with this kind of network
 - OLS estimate is upwards biased

COMMENTS

- Concern relevant?
 - Connected and non-connected firms look very different on observables
 - Concern is that they are also different on unobservables
- Matching?
 - Comforting
 - But... does not really help
 - Similar identifying assumptions

COMMENTS

- Attempt 1: Within-firm variation?
 - Can you look at firms that switch from being connected to non-connected (or vice-versa)?
 - Remaining concern: unobserved heterogeneity could be time-variant; i.e., firms (can) hire connected in good times
- Attempt 2: Within-firm-year variation?
 - Can you look at ratings of other rating agencies? (firm ratings)
 - Hypotheses:
 - Connected firms: ratings are worse from other CRAs
 - Unconnected firms: Moody ratings are worse
 - Might have connections with other CRAs

COMMENTS

- Attempt 3: Shocks to Connectedness
 - What happens if director of Moody's unexpectedly leave?
 - E.g., sick, death, (unexpected(?)) move away from CRA?
 - Do new ratings of formerly connected firms change?
 - Do firms try to find a new connected director?
 - What happens if a new director at CRA is appointed?
 - What happens to firms that become connected? (relatively exogenous)

COMMENTS

- Measure
 - BoardEx does mainly have ED and NED. Are these the right people to look at?
 - Reasonable numbers?
 - Fraction of connected firms seems very high
 - Did you require that they worked together at the same time?
 - How did you do matching?
 - Names?
 - How did you treat missing dates?
 - Army / education? What info do you exploit?

OTHER COMMENTS

- Ordered logit
 - Don't know the distribution of ratings, but...
 - OLS might be behaving well
 - Could also define dummy categories (e.g., investment grade,...)

OTHER COMMENTS

- Be careful with wording “we investigate issue that has not received any attention in the literature”
 - Cornaggia, Cornaggia, and Xia (EFA 2013)
 - Shive and Forster (EFA 2014)
- You just list papers that are “related”; place your paper within that literature. What is your contribution?

Looking forward to reading the next version!

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Good luck!