Did the Dodd-Frank Act Reduce the Conflicts of Interests between CRAs?

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The purpose of this paper is to analyze the effects that the Dodd-Frank regulation had on rating agencies adopting different business models. More precisely, a comparison between the standard issuer-paid model and the alternative investor-paid model is proposed. The motivation behind this paper relies on a large bulk of the literature that shows that the issuer-paid model is slower in identifying bad news, less timely and less accurate when compared to the alternative model. Many papers point out that the standard rating agency model is more incline to conflicts of interest that might impact the quality of credit ratings together with their information content.

This paper exploits the Dodd-Frank regulation for four main reasons. First, I want to study whether and how the difference in rating levels between the standard rating agencies, represented by S&P, and the alternative ones, represented by the Egan and Jones Rating company (EJR), changes after a disciplining regulation has been approved. Second, I want to analyze whether and which rating agency is threatened more by the regulation. Third, I want to investigate the "reputation effect" of the regulation on both the rating agencies. Lastly, I want to explore the bond market response to rating changes before and after the regulation.

The results illustrate that the regulation has a different effect on the rating levels of the two rating agencies. I find that the probability of getting lower ratings from S&P is higher after the regulation is passed. The opposite result is found for EJR. In addition, S&P appears to be threatened more by the Dodd-Frank Act as testified by a model that estimates the probability of false warnings. The third set of results focuses on the "reputation" effect, as measured by the ability of rating agencies to provide timely information to the bond market. Results suggest that standard rating agencies care more about their reputation in the post regulation period. The opposite pattern is observed for EJR. The last set of results illustrates the bond market response to rating changes before and after the regulation is passed. The evidence suggests that both S&P downgrades and upgrades are more informative, although the effect for upgrades is magnified.

Taken together, the results highlight that the two business models follow different strategies in the post regulation period with S&P being more prudent, more focused on its reputation and more effective on the bond market.