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PII: S1544-6123(19)30266-1
DOI: https://doi.org/10.1016/j.frl.2019.05.012
Reference: FRL 1194

To appear in: *Finance Research Letters*

Received date: 13 March 2019
Revised date: 7 May 2019
Accepted date: 19 May 2019

Please cite this article as: Patrycja Klusak , John Thornton , Yurtsev Uymaz , Do personal connections improve sovereign credit ratings?, *Finance Research Letters* (2019), doi: https://doi.org/10.1016/j.frl.2019.05.012

Highlights

- We examine whether personal connections affect sovereign credit ratings
- We find that, ceteris paribus, debt issued by connected sovereigns receives a better rating
- The average difference in rating is 0.58 and 0.94 points higher on a 58-point scale.
- The better rating appears to be driven by more favorable treatment of the sovereign.

Do personal connections improve sovereign credit ratings?*

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ABSTRACT

In a large sample of sovereign debt issues, we show that a personal connection between senior executives in credit rating agencies and leading politicians in the sovereign results in an improved rating. A test on bond yields suggest that the personal connection reflects a favorable treatment of the issuer.

JEL: D82, G24, L14

Keywords: Personal connections, sovereign credit ratings, information asymmetries

Wordcount: 2,503

*We are grateful to an anonymous referee for comments that improved the paper.

1. Introduction

Studying the process of sovereign credit ratings is important because ratings have been shown to affect a country's economic growth rate (Chen et al., 2016), its ability to raise capital and improve the flow of direct investment (Almeida et al., 2016; Cornaggia et al., 2017), and to impose a ceiling on ratings of other asset classes in the country (Adelino and Ferreira, 2016; Almeida et al., 2016). Moreover, changes in one country's sovereign rating can also impact on the rating of other countries, triggering instabilities and harming domestic investors in those countries (Augustin et al., 2018; Baum et al., 2016). Given these potentially important economic effects, it is not surprising that a lot of attention has been focused on the extent to which ratings are impartial. However, most of this attention has focused on the difficulties in managing potential conflicts of interest that arise from the "issuer-pays" business model that dominates the industry (e.g., Bolton et al., 2012; Mathis et al., 2009). In particular, the model has been criticized because it provides an incentive for CRAs to assign better ratings to bigger clients to win long-term business and because competition between CRAs reduces efficiency by facilitating ratings shopping in search of the most lenient rating provider. There has been less attention on how CRAs impartiality might be affected by personal connections between the agencies and the sovereign debt issuer, notwithstanding the growing literature on the importance of executive networks to business policies and decisions. In this literature, connections are typically established through one of two channels: a connection through a

common education experience (e.g., having attended the same school or university); and a connection through a shared professional experience (e.g., having served on the same executive board). These connections are viewed as either creating or destroying firm value. For example, Engelberg et al. (2012) establish that bank borrowers receive better terms when they have informal ties to lenders; Cohen et al. (2008) find that portfolio managers place larger bets on connected firms; and Cohen et al. (2010) report that sell-side analysts outperform on their stock recommendations when they have an educational link to executives in the company. A particularly relevant strand of the executive network literature focuses on the advantages to firms from political ties, including the likelihood of receiving state bail-outs (Faccio et al., 2005), being more profitable (Amore and Bennedsen, 2013), being more likely to be awarded state contracts (Schoenherr, 2018), increasing firm value (Duchin and Sosyura, 2013; Gropper et al., 2013, 2015); providing better access to external funding (Engelberg et al., 2012; Khwaja and Mian, 2005); getting regulatory and/or taxation relief (Correia, 2014); and through the better transmission of information, ideas and knowledge (El-Khatib et al., 2015). In contrast, Bertrand et al. (2018) report that firms in which the CEO had strong political connections are generally less profitable; Fracassi and Tate (2012) demonstrate that social ties between CEOs and the directors weaken board monitoring and destroy corporate value; Fracassi (2016) finds that firms where the directors are more connected with each other display similar traits in their investment strategies; and Hwang and Kim (2009) conclude that directors who are personally connected to the CEO receive higher remuneration and exhibit both lower pay-performance and turnover-performance sensitivity. Research specifically on the role of networks in affecting credit ratings appears to be limited to Khatami et al. (2016) who report that personal

connections between private debt issuers and rating agencies result in a better rating than would otherwise be the case, which they attribute to the connection resulting in a lower degree of asymmetric information as the connection reveals "soft" information about the debt issuer; in the absence of the additional information, the CRA would likely have given a more conservative rating to protect its reputation.

In this paper, we examine whether sovereign ratings are affected by the presence of a personal connection between the prime minister in the sovereign and senior executives in the CRA. We focus on the prime minister in the sovereign on the basis that this link is likely to reflect the most influential personal connection for the CRA. We establish the connection through the common educational experience channel and examine its impact on the credit rating awarded by the CRA. We hypothesize that such an effect can be explained by two paradigms. Firstly, personal connections may act as an information channel. The literature has established that when CRAs are not able to acquire enough information about the issuer they are more likely to issue more conservative ratings (Bannier et al., 2010). However, a connected issuer might be less opaque to the CRA and the need for conservatism when issuing its rating could be diminished—i.e., the connection acts as a channel of information that enables a CRA to better understand the financial situation of the sovereign and issue a more optimistic rating without compromising its reputation. Secondly, the rivalry between CRAs in sustaining their market share might put pressure on them to act in the best interest of the issuers. For example, Bolton et al., (2012) show that competition between CRAs results in issuers shopping for their ratings, and Jiang et al. (2012) show that conflict of interest due to the issuer-pay model results in

higher ratings. Thus, senior executives in CRAs personally connected to politicians might show favoritism by pushing for a more optimistic sovereign rating than would be the case without the connection. On the basis of the above, we hypothesise that:

Ho: Connected sovereigns receive a higher credit rating than unconnected sovereigns, other things being equal.

As far as we are aware, this is the first study of the impact of personal connections on sovereign credit ratings. In addition to our developing this particular field of the sovereign rating literature, we contribute to the wider literature on the determinants of credit ratings that has been shown to include, for example, the length of the relationship between the debt issuer and the rating agency (Mählmann, 2011), reputational concerns (Mathis et al., 2009), the size of the rating fee (Butler and Cornaggia, 2012), and whether or not the rating was solicited by the debt issuer (Bannier et al., 2010; Van Roy, 2013).

2. Model and data

We examine the effect of personal connections on sovereign credit ratings by estimating the following panel regression:

$$R_{it} = \propto_i + \vartheta_i + \varphi_t + \beta_1 CONN_{it} + \beta_2 UNSOL_{i,t} + \beta_3 BTIES_{it} + \beta_4 PTEN_{it}$$

$$+\beta_5 PAGE_{it} + \beta_6 ELEC_{,t} + \gamma X_{it} + \varepsilon_{it}$$

(1)

where $R_{i,t}$ is the observed rating category assigned to the sovereign and is based on monthly long-term foreign-currency ratings by Standard &Poor's between January 2000 and November 2017, and where ratings are defined using a scale ranging between 1-58 that includes watch and outlook status (see Appendix 1). ϑ_i and φ_t are country and year fixed effects, respectively. To establish the presence of a personal connection between senior executives in the CRA and prime minister in the sovereign, we follow Cohen et al. (2008) and focus on shared educational backgrounds, on the basis that these often reflect aligned interests with educational institutions being the largest beneficiary of an individual's charitable donations, and that school relationships are often more homophilous than those formed in other settings. Unlike other measures such as lobbying expenditures, educational backgrounds allow us to detect direct connections between senior executives and politicians that would be more difficult to infer from contributions to political campaigns (Jagolinzer et al., 2017). Accordingly, our personal connections variable, $CONN_{i,t}$ is a dummy variable that takes the value of 1 (0 otherwise) if there is a shared education experience between at least one senior CRA executive and the prime minister in the sovereign. We rely on CRA annual reports and national government websites to identify the names of CRA executives and prime ministers in office and gather information on their respective education backgrounds from BoardEx. We control for possible upward bias in the credit rating that might result from the rating having been solicited by the debt issuer by including the variable $UNSOL_{i,t}$, which is a 0,1 dummy variable with 1 indicating

that the rating was not solicited (0 otherwise), and for possible bias in the credit rating that might result from a lengthy relationship between the debt issuer and the rating agency (Mählmann 2011) by including the variable $BTIES_{i,t}$, which is the number of years since the sovereign was first rated by the CRA.

We also include several variables likely to be relevant for the effectiveness of the personal connection as an information channel or as a source of pressure on the CRA to act in the best interest of the sovereign. First, we include tenure of the prime minister, $PTEN_{it}$, as a proxy for the power of the prime minister on the assumption that longer-serving prime ministers are more powerful. Second, we include a proxy for the length of the personal connection, which is the prime minister's age, $PAGE_{it}$. As our personal connection variable is a dummy that may indicate a shared connection with more than one senior CRA executive, the calculation of the length of the relationship is not straight forward and we simply assume that the relationship will have been longer the older is the prime minister. Third, we include the frequency of parliamentary elections, $ELEC_{it}$, the outcomes of which can be expected to impact on the durability of the personal connection. Fourth, we control for the possible impact on the strength of the personal connection of the 2007-08 financial crisis, for example, in case the connection was weakened as a result of more effective regulation in the post crisis period. The vector X_{it} includes the sovereign risk rating in the previous period and economic variables (GDP growth, inflation, external current account balance, and investment) that have been shown in the literature to impact on sovereign ratings (e.g., Cantor and Packer, 1996).

The panel comprises 441 rating actions for 38 sovereigns from January 2000 to November 2017. Summary statistics and the countries included in the sample are shown in Table 1 and variable definitions and data sources are presented in Appendix Table 2. Two potential problems in estimating Equation (1) are reverse causality, where the rating of a debt issue may lead to the creation of a personal connection, and self-selection bias as ratings can be solicited by the issuing company. The first problem appears to be unlikely given that the connections were formed long before the issue of the sovereign being rated. The second problem we deal with by including the solicitation status of the rating in the estimates.

3. Empirical results

The estimated coefficients from fixed effects panel estimates are reported in Table 2 where the control variables are entered sequentially. The results indicate strongly that personal connections play an important role in determining sovereign credit ratings, with the result robust to a large number of controls. The coefficients on the personal connection variable are always positive and statistically significant and suggest that a prior educational connection between CRA executives and prime ministers increases the sovereign credit rating by between 0.58 and 0.94 points on a 58-point scale compared to a non-connected sovereign. In addition, sovereign credit ratings appear to be impacted positively by the length of the business relationship, the power of the prime minister, and the length of the personal relationship, whereas ratings that are unsolicited by the sovereign tend to be lower than those that are

solicited. Of the other control variables, higher sovereign ratings are associated with the prior rating, low inflation, strong current account positions, and higher levels of investment. Parliamentary elections and the financial crisis appear to have had no statistically significant impact on ratings.

As discussed above, a personal connection being associated with a higher credit rating is subject to at least two interpretations. The more generous interpretation is that a personal connection is a channel for reducing information asymmetries between the CRA and the sovereign, which reduces the incentive for the CRA to issue a more conservative rating in the absence of the information. The less generous interpretation is that the connection results in a higher rating because of "favouritism." To try to distinguish between these possibilities, we adopt a test suggested by Khatami et al. (2016) in the context of private debt ratings. In an efficient financial market, if connected issuers receive artificially higher ratings due to more favorable treatment, we would expect sovereign bond yields to adjust upwards over time as more information about the sovereign eventually becomes available. On the other hand, if personal connections act as an information channel, the later increase in bond yields should not occur. In Table 3 we show the differences between mean bond yields of a sample of 15 sovereign debt issuers in the periods before and after the personal connection was established (through a common education) with the rating agency. Specifically, Panel A of the table compares the mean bond yields of sovereigns at the time the connection was established to the mean bond yield in the period before the connection. A simple univariate t-test shows that there was no significant difference between the two means. In Panel B, we compare the mean

bond yield 12 months after the connection was established with the mean yield for the period before the connection. In this case, the mean bond yield after the connection was established is higher, and the difference in means is statistically significant. This is consistent with the rating assigned to the connected sovereign having been driven by a favourable treatment of the issuer.

4. Conclusions

In a panel of credit ratings of 38 sovereigns, we find that a prior personal connection between senior executives in the rating agency and the prime minister in the sovereign is associated with a more positive credit rating of the sovereign. This result is robust to the inclusion of several control variables likely to impact of the personal connection as either an informal information channel to the CRA or as source of pressure on the CRA, as well as to the inclusion of economic variables that the previous literature has found to be important in the determination of sovereign credit ratings. Developments in sovereign bond yields following the establishment of the personal connection suggest that the higher credit rating of connected sovereigns reflects a more favorable treatment of the issuer by the CRA. We view our results as an important first step in the development of a literature on the impact of personal connections on sovereign credit rating, as well as a contribution to the wider literature on the determinants of credit ratings. In addition, our results have an important implication for financial regulation in that they need to recognize that personal connections with CRAs give sovereigns a clear advantage in the rating process and to ensure that this advantage reflects the information channel rather

than (as our results—albeit weakly suggest) "favoritism" exhibited by the CRA. In future research, we propose to examine the robustness of our results to a larger sample of ratings and agencies, and to a broader array of personal connections, including other thank linkages through a common education.

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Table 1
Summary statistics and country sample

A. Summary statistics

	Observations	Mean	Median	Standard deviations	Maximum	Minimum
Credit rating	8170	41.67	43.00	14.28	58.00	1.000
Personal connection	8170	0.100	0.000	0.300	1.000	0.000
Business ties	8170	26.62	25.89	8.430	42.97	8.990
Unsolicited rating	8170	0.090	0.000	0.290	1.000	0.000
Inflation	8170	3.760	2.380	4.970	51.47	-1.330
Current account to GDP	8170	-0.730	-0.850	7.070	28.84	-23.31
Real GDP growth	8170	0.510	0.580	1.230	3.690	-5.490
Total investment to GDP	8170	22.24	22.59	5.000	57.99	9.830
Politician tenure (months)	8170	47.88	35.00	44.16	212.0	1.000
Length of connection (months)	8170	424.3	411.4	102.6	752.2	202.8
Elections	8170	0.020	0.000	0.140	1.00	0.000

B. Countries in the sample
Austria, Azerbaijan, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Georgia, Greece, Hungary, Iceland, Ireland, Italy, Kazakhstan, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, Ukraine, and United Kingdom.

Table 2

Panel least squares estimates of the determinants of sovereign credit ratings—dependent variable: sovereign credit rating

	1	2	3	4
Personal connection	0.857***	0.583***	0.942***	0.941***
	(0.250)	(0.224)	(0.266)	(0.266)
Business ties	1.147***	1.068***	1.153***	1.155***
	(0.015)	(0.015)	(0.035)	(0.035)
Unsoliciated rating	-0.479*	-0.686***	-0.511*	-0.525*
	(0.266)	(0.243)	(0.289)	(0.289)
Inflation		-0.463***	-0.264***	-0.262***
		(0.022)	(0.035)	(0.035)
Current account		0.094***	0.098***	0.096***
		(0.016)	(0.017)	(0.017)
GDP growth		0.104	0.521***	0.546***
		(0.070)	(0.079)	(0.081)

Investment		0.639***	0.277***	0.275***
		(0.020)	(0.022)	(0.022)
Prime minister tenure			0.158**	0.153*
			(0.080)	(0.081)
Prime minister age			0.009***	0.009***
			(0.001)	(0.001)
Elections			-0.375	-0.367
			(0.402)	(0.402)
Prior rating			0.745***	0.738***
			(0.103)	(0.104)
Financial crisis				-0.344
				(0.247)
Observations	8134	8134	7986	7986
R^2	0.861	0.889	0.948	0.998
Year fixed effects	Yes	Yes	Yes	Yes
Country fixed effects	Yes	Yes	Yes	Yes

Notes: The dependent variable is the sovereign credit rating ranges on a scale between 1 to 58. Standard errors in parenthesis. ***, ** and * indicate statistical significance at the 1, 5 and 10% levels, respectively.

Table 3

Univariate 10-years sovereign bond yield analysis

	(1)	(2)	(3)
	Bond yield mean	Difference in mean (basis points)	Difference p-value
Average bond yield at time of the connection			
Connected period	4.198		
Non-connected period	4.012	-0.186	-1.264
Average bond yield one year after the connection			
Connected period	4.405		
Non-connected period	3.876	-0.529***	-3.445

Notes. *** indicates statistical significance at the 1% level.

Appendix 1

Transposition of S&P credit rating letter-grades into numerical scores

S&P rating	Credit rating scale
AAA	58
AA+	55
AA	52
AA-	49
A+	46
A	43
A-	40
BBB+	37
BBB	34
BBB-	31
BB+	28
BB	25
BB-	22
B+	19
B	16
B-	13
CCC+	10
CCC	7
CCC-	4
C	1
SD	1

Appendix 2.

Variable definitions and data sources

Variable	Definition	Data source
Sovereign credit rating	Transposition of Standard & Poor's (S&P) sovereign credit rating letter-grades into numerical scores (see Appendix 1)	S&P credit reports
PM connection	A dummy variable that takes the value of 1 (0 otherwise) if there is a shared education experience between at least one senior CRA executive and the Prime Minister of the sovereign	BoardEx
Business ties	The number of years since the sovereign was first rated by S&P	S&P annual reports
Unsolicited rating	A 0,1 dummy variable whereby 1 indicates that the rating was not solicited by the sovereign (0 otherwise).	S&P annual reports
Inflation	Annual percent change in the consumer price index of the sovereign	WDI
Current account	External current account balance of the sovereign in percent of GDP	WDI
GDP growth	Annual percent change in the real GDP of the sovereign	WDI

Total investment	Total fixed investment (public and private) if the sovereign in percent of GDP	WDI
Politician tenure	Number of months that the politician has been in office	ParlGov
Length of S&P-political connection	Number of months since the connection between the S&P senior executive and the politician was established	BoardEx and authors' calculation
Elections	Dummy variable that takes the value of 1 in the month and year of the parliamentary elections for each country in the sample and 0 otherwise	EED
Financial crisis	Dummy variable that takes the value of 1 during 2007-09 and 2010-12 and 0 otherwise	Authors' calculation

Notes: WDI is the World Bank's World Development Indicator database; ParlGov is the University of Bremen's Parliament and Government Composition database; EED is the European Election database.