# Optimistic Gatekeepers: Credit Rating Optimism around M&A Deals by Bonsall, Koharki, Lock, and Neamtiu

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# Outline:

1. Anatomy of an M&A.
2. Implications: Why this paper matters.
3. The ability question.
4. Original Sin.
5. Minor items (in case I talk too fast)

# Anatomy of an M&A:

1. A wants to buy B.
    - **a.** Buy with debt.
    - **b.** Something else.
2. if **1.a** then AB is:
    - **a.** Less creditworthy.
        - To influence **3.** AB can disclose a 'deleveraging plan'.
    - **b.** Not less creditworthy.
3. if **2.a.** CRA reviews the new firm and:
    - **a.** decides that **2.a.** will persist, but is not large enough to downgrade.
    - **b.** decides that **2.a.** will persist, and is large enough to downgrade.
    - **c.** decides that **2.a.** is large enough to downgrade, but will not persist.

# Main result:

- "a one notch increase in $\Delta$Abrating[-1,1] is associated with a 3.1 (2.8) percent increase in downgrade likelihood"
  - CRAs are sometimes wrong about the persistence of post-merger creditworthiness. i.e. they choose **3.c.** and then downgrade later.
- "one notch increase in $\Delta$Abrating leads to a 2.6 (4.3) percentage point decrease (i.e., a 6.1 (10.6) percent decline from the unconditional mean) in the probability of deleveraging to the pre-acquisition leverage level during the two (three) year post-merger period."
  - Firms respond to CRAs determination that the post-merger decrease in creditworthiness is transient, by making it persist. i.e. **3.c.** causes itself to be false.

# How often does this happen?

- 1,939 acquisitions.
- 26.8% (520) should be downgraded by the CRAs.
- 17.7% (343) are downgraded.
- 9.1% (177) should have been downgraded, but were not.
- These 177 are now 3.1 percentage points more likely to be downgraded than average in [1,3].
- The average is 20.3% (36 downgrades), and we expect 6 excess downgrades.

# Why this paper matters:

1. Another case where CRA's fall short.
   - Prior: CRAs are underskilled, underfunded, and have bad incentives.
   - Documenting how CRAs fail is critical to financial stability (and preventing markets from unraveling).
2. Potential impacts on the market for corporate control.
   - Banks fund more M&As that they would if the had better ratings.
   - Leverage-Credit rating disconnect, after M&A's. This seems like a prime opportunity for claim dilution.
3. Is this an incentive problem or an ability problem:
   - This is a policy question. Changes what we do more than it changes the contribution of the paper.
   - Do we need better CRA's or better incentives?
   - The authors have put a lot of thought into this question.

# Incentives or Ability?

The current draft takes a strong stand on ability.

> *"We find that, on average, CRAs are not* ***able*** *to correctly identify which M&As lead to only temporary increases in credit risk: greater rating optimism around mergers is predictive of a higher likelihood of post-merger rating downgrades and negative merger outcomes."*

Do you need to take a stand here? Separating these convincingly will be hard.

# Incentives or Ability? (Section 4.1)

*"Those explanations [(i.e. stale ratings, and distorted incentives)] are particularly unlikely in our setting given that M&A deals attract significant attention from stakeholders, increasing the reputational stakes for agencies."*

# Incentives or Ability? (Section 4.1)

- **But part of the motivation of the paper is that this practice *is itself* harming the CRAs' reputations. See e.g. fn 4:**
  *In particular, several investors and analysts expressed concerns about ratings quality around highly leveraged acquisitions at the SEC's Fixed Income Market Structure Advisory Committee meeting in October 2018. Morgan Stanley analysts stated that "M&A has contributed to near record-high investment grade leverage levels today and the deterioration in ratings quality of the investment grade index this cycle" (Stratmann et al., 2018). . . .*

# Incentives or Ability? (Section 4.1)

*J.P. Morgan analysts expressed a similar view, saying "...this has raised concerns in the investment community that the ratings post some M&A transactions may be too high (Beinstein et al., 2018)." A recent Wall Street Journal article also highlighted S&P and Moody's optimistic ratings and consistently missed deleveraging predictions for some highly leveraged acquirers (Banerji and Podkul, 2019).*

# Incentives or Ability? (Section 4.1)

> *"Our finding that both abnormal optimism and pessimism predict future rating corrections suggests that CRAs' incentives to inflate ratings are not a sufficient explanation for CRA's rating behavior around acquisitions. Rather, our evidence is consistent with CRAs' rating behavior for acquirers reflecting a methodological focus on the long-term implications of M&A-related shocks to credit risk."*

Based on Table 2 optimism and pessimism appear to occur in different parts of the distribution of creditworthiness on average.

# Incentives or Ability? (Section 6.1)

*"Moreover, the lack of a statistically significant association between $\Delta$AbRating and the incentive conflict proxies supports our prior evidence in Section 3 that CRAs' incentives to cater to acquirers' preferences around merger deals are unlikely to be a primary explanation for acquisition-related increases in rating optimism.*

- **fn 26 is the most convincing argument that the effect is not driven by incentives.**
  *While our evidence does not imply that incentive conflicts do not influence the level of rating optimism at a given point in time during an acquisition, it does suggest that changes in rating optimism around acquisitions are unlikely to be explained by incentive conflicts.*

# Original Sin.

*This rating "grace period" is consistent with the leading rating agencies' stated objective of maintaining rating stability by only responding to long-term changes in default risk, reducing the likelihood of* ***costly rating reversals*** *(Cantor and Mann, 2003; Beaver et al. 2006).*

- It's hard to rule out the incentive explanation when the stated objective of the practice is a sell-side concern (i.e. these downgrades are costly to borrowers not lenders).
- **NB: your baseline (Egan-Jones) is a buy-side rating.**
- Is this a stand you have to take?
- Can you strengthen the ability side of the argument?

# Minor items (in case I talk too fast)

- How much excess leverage?
- How many excess M&As? What does this suggest for policy?
- Claim dilution, and other borrower lender agency problems. What else could go wrong while the CR is wrong.
- Why doesn't the market for leveraged M&A's unravel? What is holding it together? Or does this not matter?
- Is "shock" the right word?
- How does this relate to NRSRO status (NB: Egan-Jones is also an NRSRO)? i.e. considered "issuer of credible and reliable ratings by the predominant users of securities ratings."