MARKETS

Wall Street credit analysts more apt to cut ratings if the president is of opposing party

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KEY POINTS

- Analysts not affiliated with the sitting U.S. president's party are more apt to downgrade corporate credit ratings, according to a new study.
- The University of Chicago and Cornell find an analyst who isn't in the president's political party cuts ratings 0.015 notches more, accounting for a 10 percent change.
- The impact is exacerbated during periods of intense partisanship. Lower credit ratings tend to buoy the cost of borrowing for firms.

Analysts who judge companies for credit risk can't escape their own political bias in rating bonds, a new research paper says.

Those who aren't affiliated with the political party of the sitting U.S. president are more apt to downgrade corporate credit ratings, according to the study from the University of Chicago and Cornell University. The researchers found that the effect is more pronounced during times of high partisanship and for analysts who vote frequently.

"Using a novel dataset that links credit rating analysts to party affiliations from voter registration records, we show that analysts who are not aligned with the president's party are more likely to adjust ratings downward," Elisabeth Kempf of the University of Chicago and Margarita Tsoutsoura of Cornell wrote.

The implications of such biases, even if unintentional, are notable and can have a real influence on the financial health of companies, the economists said. Lower credit ratings raise the cost of borrowing, for example.

Consistent with prior studies, Kempf and Tsoutsoura demonstrate that a credit downgrade cuts the company's stock an average of 1.8 percentage points. And, they said, the market doesn't pay attention to these political affiliations.

"We find little evidence that the stock price response to a downgrade differs significantly when the downgrade is announced by an analyst who is ideologically misaligned with the president," the researchers wrote. "The stock market does not seem to correct analysts' ideological bias."

Kempf and Tsoutsoura studied analysts at the three big agencies, Moody's Investors Service, Fitch and Standard & Poor's, which rate companies on similar scales from top investment grade to junk. They found an analyst not affiliated with the president's on credit ratings is significant and accounts for an approximate 10 percent change.

At S&P, Fitch and Moody's, 55 percent, 46 percent and 39 percent of the analysts are Democrats, respectively. The study included 449 analysts responsible for rating at 1,778 firms between 2000 and 2015. That covers the end of the Democratic Clinton administration, eight years of a Republican Bush administration, and seven years of the Democratic Obama administration.

The impact is exacerbated during periods of intense partisanship. The researchers found that a one-standard-deviation increase in political conflict as measured by the Philadelphia Fed's Partisan Conflict Index magnifies a credit rating change by 0.0091 notches, increasing the distortion by 75 percent.

Lower credit ratings tend to buoy the cost of borrowing for firms and influence their financial policies and investment decisions. Prior analysis has shown that a 0.7-notch decrease in a credit rating is associated with a 61 basis point increase in bond yields and an 8.9 percentage point drop in firm investment.

Combining those estimates with the latest study leads to a rough conclusion that replacing an analyst who is politically aligned with the president with an analyst who is ideologically misaligned leads to a difference in bond yields of 5.23 basis points and a 0.76 percent percentage-point difference in firm investment.

"Distortions in credit rating decisions may have real effects," the researchers wrote. "Given the documented increase in political polarization, it is important to understand the potential implications of this trend for the U.S. economy."

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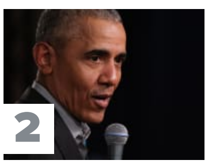

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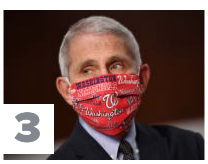

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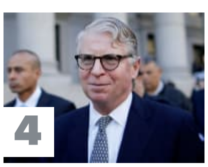

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