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Divergence in credit ratings



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ABSTRACT

During the recent credit crisis credit rating agencies (CRAs) became increasingly lax in their rating of structured products, yet increasingly stringent in their rating of corporate bonds. We examine a model in which a CRA operates in both the market for structured products and for corporate debt, and shares a common reputation across the two markets. We find that, as a CRA's reputation becomes good enough, it can be optimal for it to inflate its ratings with probability one in the structured products market, but inflate its ratings with probability zero in the corporate bond market.

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1. Introduction

A striking feature of the period prior to the 2008 crisis is the divergence of rating behavior between the bond and structured product markets: structured product ratings becoming more lax, bond ratings becoming more conservative. For instance, Blume et al. (1998) find a trend over the period 1978–1995 towards increasingly conservative ratings in bond markets, and Baghai et al. (2011) confirm that this trend continued throughout the period leading up to the 2008 crisis. Meanwhile, studies of structured product markets find evidence of the opposite trend. In particular, Ashcraft et al. (2009) document how, between 2005 and 2007, subordination levels on mortgage-backed securities remained flat while objective risk measures increased (see also Stanton and Wallace, 2010).

This divergent rating behavior across markets is not explained by existing theory. The analysis closest to ours, Mathis et al. (2009), MMR hereafter, models a monopoly credit rating agency (CRA)

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that operates in both the corporate bond and structured product markets. However, MMR do not model CRA rating behavior in the bond market; instead, this market is captured only through the inclusion in the CRA's payoff function of an exogenous term capturing its constant revenue from rating bonds. Their model is, therefore, unable to shed light on the divergence phenomenon. Opp et al. (in press) present a model in which, as in ours, the incidence of rating inflation is linked to the complexity of the underlying securities. Both models are able to explain a cross-sectional difference in rating standards between (simple) bonds and (complex) structured products, but the Opp et al. model does not account for the time series pattern of divergence in rating standards across markets, i.e., why bond market ratings became strictly more conservative at the same time as structured product ratings were becoming increasingly lax.

We propose an explanation of the divergence in credit ratings based on the role of reputational spillovers between markets. In our model, a CRA operates sequentially in a bond market and a structured product market. The two markets are interdependent as CRAs acquire a common reputation across both markets that is jointly influenced by rating quality in each. Realized outcomes in each market generate bidirectional reputational spillover effects, which can be either positive or negative. This extends the model of MMR, which allows only for a one-off unidirectional spillover from the structured product market to the bond market: bond market revenue is forfeited if the CRA loses its reputation in the structured products market.

To emphasize the role of reputational spillover effects, we assume the only difference between the two markets is that, in the relatively simple bond market, investors can observe project quality ex post, and so infer the CRA's type (truthful or opportunistic) with certainty when a (bad) project that receives a good rating fails, i.e. perfect monitoring. However, in the (complex) structured product market, project failure does not fully reveal the CRA's type, i.e. imperfect monitoring.

Over the decades preceding the 2008 crisis, the major CRAs built substantial reputations for providing informative ratings (White, 2010). When, accordingly, we examine CRAs with sufficiently good reputation, our model predicts that divergent rating behavior between markets may pertain: an opportunistic CRA that is sufficiently far-sighted would find it optimal to lie about bad projects with probability one in the less informative market (structured products), but truth-tell about bad projects with probability one in the informative (corporate bonds) market. This result suggests an explanation based on reputational spillovers for the observed differences in rating behavior across markets in the pre-crisis period: CRAs may choose to stiffen rating standards in the informative market (bonds) to reduce the likelihood of a loss of reputation that would jeopardize their growing revenues (arising from increasing lax rating standards) in the less informative market (structured products).

Our findings also have implications as to whether the concern for reputation is sufficient incentive for CRAs to provide independent and objective credit-risk analysis, rather than accommodate the interests of issuers. The literature has not, so far, provided a clear answer. Part of the reason, we argue, is a failure to account for the divergent rating behavior of CRAs in the corporate bond and structured product markets. Hence, Covitz and Harrison (2003) examine the US bond market between 1997 and 2002 and conclude that reputation concerns effectively discipline CRAs. However, analyses that instead consider the market for structured products reach the opposite conclusion (Ashcraft et al., 2009; Stanton and Wallace, 2010; He et al., 2011). Our findings suggest a resolution: a concern for reputational effects may discipline a CRA's operations in markets where monitoring is perfect (ex post), but fail to do so when monitoring is imperfect.

2. Model

There are two markets for finance: a market for corporate bonds (market A) and a market for structured products (market B). In each period $t = 0, 2, 4, \dots$ a firm wishes to issue corporate bonds in market A to finance an investment project, and, for the same reason, in each period $t = 1, 3, 5, \dots$ a firm wishes to issue a structured product in market B. Thus markets A and B operate in sequence. Project quality is *a priori* unknown, including to the issuer. Irrespective of the means of finance, a project can be good with probability λ , or bad with probability $1 - \lambda$. There is a monopoly CRA that operates in both markets. The CRA perfectly observes the quality of each project financed in market A (corporate

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