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The quality of credit ratings: A two-sided market perspective

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ABSTRACT

This paper presents a formal model of a credit rating agency. I study the consequences of the transition from an “investor-pays” model to an “issuer-pays” model on the quality standard of credit ratings chosen by the agency. I find that such a transition is likely to generate a degradation of the quality standard, which may fall below the socially efficient level. Finally, I discuss empirical implications and several reform proposals to the business model of credit rating agencies.

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1. Introduction

Credit rating agencies are for-profit companies specialized in assessing the credit worthiness of a corporation or security. They fulfill a double role of certification (by granting ratings to potential security issues) and dissemination of information (by distributing rating reports to investors). In their beginnings,¹ credit rating agencies provided ratings of an issuer free of charge and financed their operations through the sale of thick rating reports to investors. Credit rating agencies started to charge issuers for ratings in the early 1970s. Nowadays, most of the revenue of the three major credit rating agencies (Fitch Ratings, Moody's Investors Service and Standard & Poor's Ratings Services) accrues from issuer's fees, while investors get rating reports free of charge.²

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¹ The first rating of a railroad corporation's bonds was published by John Moody in the United States in 1909. Poor's Publishing Company issued its first ratings in 1916, Standard Statistics Company in 1922, and Fitch Publishing Company in 1924. For detailed reviews of the genesis of the credit rating industry see Cantor and Packer (1994), Hill (2004) and Sylla (2002).

² See, for example, Moody's Corporation (2007). In addition to the three major credit rating agencies, there are specialized and smaller agencies. Some of them get their revenue from investor's fees but, according to the United States Securities and Exchange Commission (2009), rating agencies operating under the issuer-pays model have granted over 98% of the total currently outstanding credit ratings. For an analysis of the structure of the credit rating industry see White (2002).

The transition from the “investor-pays” model to the “issuer-pays” model raised concerns about the quality of credit ratings. Several recent cases have revived the concerns. For example, the bad performance of the major agencies in rating structured finance products has been suggested to be at the heart of the subprime crisis.³ The big Icelandic banks that failed in 2008 were awarded AAA ratings by *Moody's Investors Service* in 2007, and Enron Corporation was rated investment grade by the major rating agencies just four days before it declared bankruptcy in 2001. Moreover, a preliminary analysis of the default rate of corporate bonds rated by *Moody's Investors Service* between 1970 and 2007 (see [Appendix A](#)) suggests the existence of a degradation of the quality of credit ratings. Such default rate (which is an *ex post* measure of the quality of ratings) follows a positive and significant temporal trend after filtering transitory macroeconomic effects out. This result suggests that the rating agency becomes more permissive to give ratings at the same time that it changes its pricing model.⁴

This paper presents a formal model of a credit rating agency that acts as a platform between issuers of securities (e.g., corporate bonds) and investors. From this two-sided market perspective, I study the consequences of the transition from the investor-pays model to the issuer-pays model on the quality standard chosen by the rating agency. The main finding is that such a transition may generate a degradation of the quality standard, which may fall below the socially efficient level. There is a conflict of interest inherent in the issuer-pays model: rating agencies may have an interest in generating business from the firms that seek ratings, which could conflict with providing ratings of integrity. Under the investor-pays model, however, reducing the quality standard of credit ratings could reduce their demand from investors, and so damage the business of the agencies.

In the model, a credit rating agency certifies the quality of potential security issues by granting ratings which I assume for simplicity to be binary: either “bad” or “good”. I also assume that investors are not ready to buy securities that have received a bad rating. Without loss of generality, I can thus consider that a rating is always “good”, while a “bad” rating is equivalent to a rating denial.

From a normative point of view, I show that the rating agency should give ratings only to high-quality securities when the marginal utility of issuers is sufficiently low, and should also give ratings to a positive, and strictly lower than one, fraction of low-quality securities otherwise. The intuition for these results is as follows. To give ratings to low-quality securities reduces the surpluses of investors and high-quality issuers because the average quality of the group of rated securities decreases. Thus, it is socially optimal to give ratings to low-quality securities if and only if the increment in social welfare due to the incorporation of low-quality issuers to the market for rated securities is larger than the decrement in social welfare due to the reduction in the surpluses of investors and high-quality issuers (i.e., if the marginal utility of low-quality issuers is high enough). However, to give ratings to all low-quality securities will break the market down because the quality of the group of rated securities will fall below the investors' reservation value.

From a positive viewpoint, I show that under the investor-pays model the quality standard chosen by the credit rating agency is equal to or higher than the socially efficient level. The reason for this result is that the rating agency does not internalize the surplus of issuers from getting their securities rated. Consequently, it only rates high-quality securities. On the contrary, under the issuer-pays model, the rating agency may choose a quality standard below the socially efficient level. In this case, the rating agency does not internalize the disutility that investors suffer from investing in low-quality securities. Hence, it may prefer to rate some low-quality securities in order to increase its profit. Thus, the transition from the investor-pays model to the issuer-pays model (weakly) creates a degradation of the quality standard chosen by the rating agency, leading to a degradation of the average quality of the group of rated securities.

³ On July 8, 2008, the [United States Securities and Exchange Commission \(2008\)](#) released findings from extensive staff examinations of the three major rating agencies that uncovered significant weaknesses in ratings practices: “One analyst [at one of the major credit rating agencies] expressed concern that her firm's model did not capture ‘half’ of the deal's risk, but that ‘it could be structured by cows and we would rate it.’” (p. 12).

⁴ [Mathis et al. \(2009\)](#) provide similar evidence for the case of structured finance products. Moreover, the existence of rating agencies that obtain their revenue exclusively from investors presents an interesting opportunity for comparisons. According to [Beaver et al. \(2006\)](#) and [Johnson \(2003\)](#), the ratings by the Egan-Jones Rating Corporation, a small rating agency that works under the investor-pays model, are timelier and lead the ratings by *Moody's Investors Services* and by *Standard & Poor's Ratings Services*.

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