

THREE ESSAYS ON RATING QUALITY

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Rating quality: A literature review

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Abstract

This paper reviews the theoretical and empirical literature dealing with the current topic of rating quality. Due to the close interrelation of ratings with the financial system, it is crucial to understand what exactly determines their accuracy. To provide a unique and holistic overview on central insights from recent research, I compare 122 published and working papers along two perspectives and several sub-dimensions. In particular, I show that both internal and external forces determine the rating process, thereby either leading to an increased or a decreased level of rating quality, and moreover, I derive various implications for further research.

JEL classification: G24

Keywords: Credit ratings, rating agencies, credit risk

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Is there a 'boom bias' in agency ratings?

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Abstract

Theory predicts rating agencies' incentive conflicts to be stronger in boom periods, thereby leading to biased ratings and a reduced level of rating quality. We empirically investigate this prediction using a large data set of almost 10,000 U.S. corporate bonds, publicly issued between 1990 and 2007. Our main findings are twofold: First, initial ratings appear to be overly optimistic during boom periods when compared to initial bond spread levels or 'incentive-free' benchmark ratings. Second, boom bond ratings are more heavily downgraded and perform poorly in predicting defaults from an ex post perspective. In several robustness checks we show that the observed 'boom bias' is not resulting from changes in credit-worthiness, adjustments in rating standards over time, competitive pressure, or investor demand, but rather from rating agencies' incentive conflicts.

JEL classification: G01, G12, G24

Keywords: Credit ratings, credit risk, conflicts of interest, yield spreads

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The disciplinary role of CDS markets: Evidence from agency ratings

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Abstract

Since the beginning of the financial crisis there have been various attempts to correct weaknesses within the rating process. Most of these initiatives aim at incentivizing rating agencies by increasing regulatory pressure. We argue that there is another way to discipline agencies: the credit default swap (CDS) market. Based on a sample of more than 4,000 corporate bond issues, we show that purely the existence of an external CDS benchmark leads to an increased level of rating quality. In particular, we show that ratings monitored by an actively traded CDS are more strongly correlated with bond spreads at issuance, timelier adjusted when credit-worthiness changes, better predictors of defaults, and less volatile. Moreover, we provide evidence that the observed quality improvements are most likely driven by reduced incentive conflicts stemming from increased reputational concerns.

JEL classification: G01, G24

Keywords: Credit ratings, credit risk, conflicts of interest, credit default swaps

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