credit rating agencies

History
Bond rating and the establishment of formal CRAs began in 1909 when John Moody began rating US railroad bonds, soon expanding to utility and industrial bonds. Poor’s Publishing Company followed in 1916 and Fitch Publishing Company in 1924. The business was characterised by the investor-pays model, where investors bought reports from the CRAs containing their ratings. This changed in 1970, for two reasons. First, with the advent of the photocopier free-riding became commonplace and CRAs found it difficult to sustain their business (White, 2002). Second, in 1970 Penn Central defaulted on its commercial paper obligations, creating vast mistrust among investors and a large demand by issuers for certification. The business thus changed to an issuers-pay model (Cantor and Packer, 1995). In 1975, the Securities and Exchange Commission (SEC) created the Nationally Recognized Statistical Rating Organization (NRSRO) category to designate credit ratings agencies whose ratings were recognised as being valuable for investment decisions. Standard & Poor’s, Moody’s and Fitch were given this designation immediately, and four other firms attained it in the following 17 years. By 2000, however, mergers returned the number of NRSROs to the big three. The SEC gave out a fourth NRSRO designation in 2003 (Dominion), a fifth in 2005 (A.M. Best), and in response to congressional legislation promoting transparency and entry in 2006 gave out three more designations (White, 2010). All of these new NRSROs, however, remain very small players in the bond and structured finance businesses.

Important Aspects of Industry Structure
1. Many regulatory agencies use ratings in evaluation, e.g. to determine capital requirements. Moreover, certain entities such as banks, insurance and pension funds are restricted to invest only in investment grade securities, i.e. BBB and above (see Cantor and Packer, 1995). This creates an artificial demand for ratings. Kisgen and Strahan (2010) demonstrate that the acquisition of NRSRO status for Dominion Bond Rating Service in 2003 changed the impact of its ratings on bond yields only in situations where this status was important. Coval et al. (2009) provide evidence that Collateralized Debt Obligations (CDOs) were inaccurately priced because ratings were overly weighted by investors. Adelino (2009) finds that while initial yields on tranches below AAA for mortgage backed securities predict future credit performance the initial yields on AAA tranches had no predictive power. This is consistent with the hypothesis that investors in AAA tranches had no other information beyond the credit ratings themselves.

2. There are large barriers to entry in the credit rating industry: Since Congress, local governments, and regulatory agencies adopted the NRSRO designation and used it
for the determination of investment grade securities (point 1), this created an ‘absolute barrier to entry’ (White, 2002). Moreover, the need to build a reputation in order to receive business is a natural barrier to entry.

3. The fact that Moody’s and S&P rate some corporate bonds which they are not paid for by issuers using public information (unsolicited ratings) is controversial. While the firms state that they are providing a service demanded by investors, some parties have raised the point that these ratings may be used to discipline issuers. Poon (2003) demonstrates that unsolicited ratings tend to be lower in general, but correcting for selection does not explain all of the variation.

4. CRAs have been able to avoid liability for problems with ratings. Under Section 11 of the Securities Act of 1933 they were immune from misstatements. Moreover, in court they have used the argument that ratings are speech and not recommendations on how to invest (Partnoy, 2002). The Dodd-Frank Financial Reform Bill passed recently exposes CRAs to liability by defining them as experts.

5. The market for corporate bond ratings is different from the market for structured finance ratings. Standard & Poor’s and Moody’s rate all corporate bonds, while the percentage that Fitch rates has been increasing. Most structured finance products receive at least two ratings, but who is rating it depends on the deal (see Ashcraft et al., 2009). The corporate bond market is established and relatively simple, and the models used are well accepted. Structured finance products are fairly new but have grown rapidly; between 1997 and 2003 global structured finance issuance grew from about $280 billion to $800 billion (Committee on the Global Finance System, 2005). These products are very complex and the methods for rating structured products have been imprecise. Errors in the ratings agencies’ data, assumptions and modelling have been found. Moreover, agencies are not required to perform due diligence on underlying loans and have difficulties retaining their best employees (Partnoy, 2002).

6. In the structured finance market, ratings shopping can occur. This means that if an issuer is unhappy with a rating, it may solicit another one, either from the same CRA or from another CRA. Moreover, ‘typically the rating agency is paid only if the credit rating is issued’ (US SEC, 2008).

**Evidence on CRAs in the corporate bond market**

There has been a large focus on the effect of announcements on the pricing of both bonds and stocks. The main finding is the asymmetry between downgrades and upgrades: downgrades have a significant negative impact on price, but there is virtually no price change following an upgrade. The effect of ratings changes on price is complex, as the impact of ratings changes is different for firms with low ratings than for firms with high ratings. Overall, there is a clear consensus that information provided by CRAs has an effect on price (Hand et al., 1992; Hite and Warga, 1997; Berger et al., 2000; Kliger and Sarig, 2000; Dichev and Piotroski, 2001; Jorion and Zhang, 2007). These findings suggest a role for CRAs in the allocation of capital process.

In terms of accuracy, Cantor and Packer (1995) show that ratings order corresponds to default rankings. Hilscher and Wilson (2009) argue that rating agencies do a poor job at forecasting default probabilities, but capture systematic default risk.