Credit market developments, ratings and regulation

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42nd Symposium Institute of Banking and Financial History
IBF Frankfurt --- 27 October 2021

Role and importance of corporate ratings – Summary

- Market structure – big 2 plus 1, 90% market share
- EU CRA regulation: aiming for better quality and more competition
- CRA evidence: ratings in market stress – GFC, Covid: cliff effects

Role and importance of corporate ratings – Points to discuss

- Market structure – big 2 plus 1
  - Q 1: How to explain IO of CRA market?
- EU CRA regulation: aiming for quality and competition
  - Q 2: How effective are regulatory rules?
- Evidence: ratings in market stress – GFC, Covid and cliff effects
  - Q 3: What is an appropriate benchmark?

Q1: How to explain the observed CRA market structure?

- Consider the economics of information in markets
  - Quality assurance of best-effort due diligence stems from *reputation*
  - Reputation is a form of *capital*, built over time, based on a proven (!) level of *forecast precision*
  - "forecast precision over time": building reputation capital needs long times series
  - "reputation capital": is the franchise value at risk in case of cheating/collusion/forbearance.
  - "return on capital" is a profitability of carrying out the rating process. High profits, high franchise value, high cost of cheating, high level of trust by investors.

Q1: How to explain the observed CRA market structure?

- Therefore, theory predicts a highly concentrated market with super-high profit margins as the guarantor of rating quality.
- Note: limiting profitability by enhancing "competition" lowers rating quality, according to the theoretical argument.
- What is wrong with this model?
- Why does regulation (and ESMA) want to change the market structure?

Q2: How effective are regulatory rules?

- If rating quality is forecast precision, then what does regulation (and ESMA) contribute to the evaluation of rating performance?
  - Eg., performance estimations in the public domain, allowing common investors to assess rating quality
  - Importantly, ensuring accessible, untainted historical data
    - Berg/Fabisik/Sautner 2021, Rewriting History The (Un)Predictable Past of ESG Ratings
    - Forensic study on rating agency Refinitiv ESG (Asset4)

Q3:Rating soundness (under stress) - what is benchmark?

- Empirical observations on rating drift, fallen angels, structured finance (rating drift)
- Benign findings
- Why?
  - Structured finance (slide 6): less affected than in GFC. Is this driven by regulatory rule of minimum retention?
  - Fallen angels (slide 7): cliff effect (IG-2-HY) “transition very limited”. Meaning less than expected, assuming historical migration probabilities?
  - Did investment managers prepare for shocks, producing “latent rating buffers”?
  - CRA market concentration (slide 8): High concentration a good message?

Policy questions to the regulator

- Profitability a sign of quality (good), or monopoly power (bad)?
- Concentration a good thing, or not?
- Is regulation based on an appropriate market model?

Thank you for your attention