

Discussion of

Reputation and Competition in the Credit Ratings
Market: Evidence from CMBS

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What is This Paper About?

- How reputations influence ratings of structured securities?
- S&P was shut out of a part of the CMBS market for more than a year because of misrepresenting a change to its rating methodology.
 - The paper compares ratings by S&P to those by Moody's and Fitch for the same tranche before and after this incident.
 - **Questions:**
 - Did S&P offer inflated ratings after the incident?
 - Do rating agencies with weak reputations cater to issuers to gain market share?

The July 2011 Incident

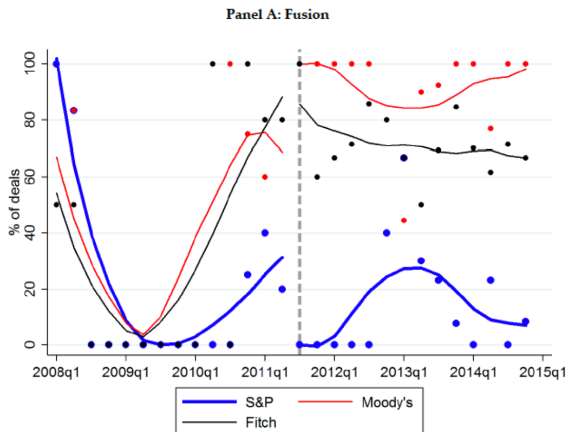
“S&P’s statements in the Presales concerning DSCRs were thus knowingly or recklessly false and misleading.”

“... badly eroded S&P’s credibility and left it frozen out of the sector.”

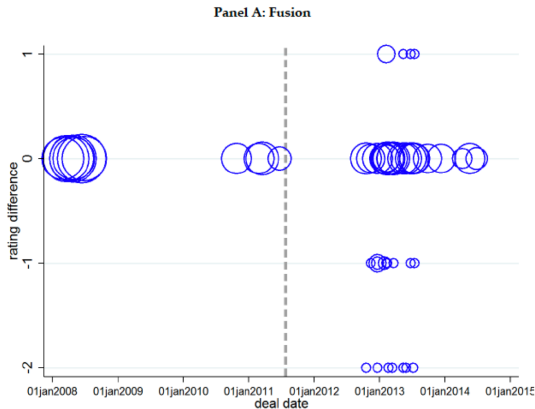
The incident was a shock to S&P’s reputation in fusion CMBS market.

Was S&P Catering to Issuers?

"... issuing optimistic ratings is a strategy that can be used by a rating agency with a weak reputation to gain market share with strong competition"



Tranche Ratings: S&P versus Other Raters



Source: Figure 4, Panel A

Conclusion in the paper: S&P was catering to issuers through higher ratings.

Gaining Market Share

- Did S&P recover market share by providing issuer-favorable ratings?
 - A rating agency with weak reputation could gain market share by:
 - Catering to issuers through higher ratings - but it further hurts reputation.
 - Charging lower fees but keeping ratings unbiased.
 - Or, providing other services such as better feedback on structuring.

Alternative Interpretation

- S&P ratings improved after September 2012. Other raters did not.
 - Ex-post performance
 - No defaults till 2014 on any of the deals that originated after 2011.
 - But, one could look at (a) rating adjustment, and (b) realized losses
 - Market participants described new S&P criteria as “lenient and as aimed at increasing market share by catering to investors”.
 - Then, issuer’s incentives to hire S&P to rate fusion CMBS are unclear.
 - Cross-sectional tests
 - Large deals and deals for issuers with large market share could also be deals that benefit the most from new criteria.
 - Non-fusion CMBS
 - S&P faced a shock that forced it to change criteria. Other raters did not face the shock.

Did Investors Not See Through the Optimistic Ratings by S&P?

After the event in July 2011, S&P reached out to issuers in September 2012 with their revised rating methodology. JP Morgan hired S&P to rate one of the deals in October 2012.

“Somewhat unusually, three additional agencies were asked to rate the deal, a peculiar signal that some investors saw as an effort by JP Morgan to quell concerns about S&P’s presence.”

Policy Implications

“Strong competition in the credit ratings market may impair the quality of ratings in some situations. Policymakers should therefore proceed with caution when aiming to increase the number of rating agencies.”

- Disconnect between the policy implications and the tests.
 - The level of competition didn't change before and after.
 - In fact, during the period from July 2011 and September 2012, S&P was shut out of the market. So competition decreased for Moody's and Fitch.
 - But, Moody's and Fitch didn't seem to change their behavior even though competition declined.

Placebo Sample

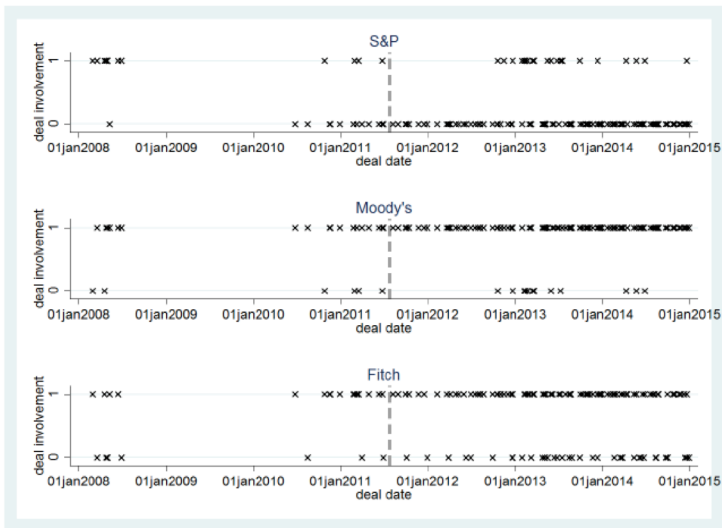
Panel B: Placebo sample period tests

| Dependent Variable: | (1) | (2) |
|---------------------------------|------------------|-------------------|
| Ind(S&P) x Ind(Post Sept. 2009) | 0.164 (0.176) | -0.036 (0.022) |
| Deal F.E. | x | |
| Seniority F.E. | x | |
| Tranche F.E. | | x |
| Rater F.E. | x | x |
| Year-quarter F.E. | x | x |
| Observations | 749 | 749 |
| Number of deals | 24 | 24 |
| Adjusted R-squared | 0.938 | 0.999 |

Source: Table 6, Panel B

Deal Involvement and Placebo Sample

Panel A: Fusion



Segmentation in Ratings: Non-Fusion Deals

Panel A: Non-fusion deal ratings

| | (1) | (2) | (3) |
|--------------------------------|------------------|-------------------|-------------------|
| Sample Period: | 2010-2012 | 2009-2013 | 2008-2014 |
| Dependent Variable: | Tranche Rating | | |
| Ind(S&P) x Ind(Post July 2011) | 0.079 (0.108) | -0.006 (0.074) | -0.065 (0.062) |
| Tranche F.E. | x | x | x |
| Rater F.E. | x | x | x |
| Year-quarter F.E. | x | x | x |
| Observations | 928 | 1,823 | 2,622 |
| Number of deals | 143 | 271 | 383 |
| Adjusted R-squared | 0.935 | 0.948 | 0.969 |

Panel B: Non-fusion market share

| | (1) | (2) | (3) |
|------------------------------|--------------------|-------------------|--------------------|
| Sample Period: | 2010-2012 | 2009-2013 | 2008-2014 |
| Dependent Variable: | Market Share | | |
| Ind(S&P) x Ind(Post Q2 2011) | -8.718 (16.501) | 4.843 (14.250) | 12.904 (12.375) |
| Rater F.E. | x | x | x |
| Year-quarter F.E. | x | x | x |
| Observations | 36 | 60 | 84 |
| Adjusted R-squared | 0.037 | -0.086 | -0.049 |

Conclusions

- Very well written. It thoroughly documents circumstances surrounding S&P's withdrawal from a part of the CMBS market for more than a year.
- The paper is addressing important research questions regarding the role of reputation in ratings business.
- The results have broader implications. Provided some suggestions to further sharpen interpretation.