All credit ratings not created equal

September 15 2011

At least one of the "Big Three" credit ratings agencies exaggerated credit scores of private debt compared to public bonds during the last 30 years, according to a new study by researchers from Rice University, American University and Indiana University.

The recent downgrade of U.S. debt by Standard & Poor's makes the study timely, and the research adds to the current debate surrounding regulatory reliance on credit ratings and the current Securities and Exchange Commission proposal to standardize credit ratings across asset classes.

For the study, "Credit Ratings Across Asset Classes: A ≡ A?," business professors John Hund of Rice, Jess Cornaggia of Indiana and Kimberly Cornaggia of American examined credit ratings assigned by Moody's Investors Service from 1980 to 2010. They compared the frequency at which different assets that received the same letter grade defaulted, and they found significant differences. Zero percent of sovereign bonds and .49 percent of municipal bonds that initially received "A" ratings defaulted, compared with 1.83 percent of corporate bonds, 4.9 percent of financial bonds and 27.2 percent of structured bonds.

"Professional investors have been uncertain about the Big Three's ratings similarities, and our findings show that their hesitation is justified," Hund said.

The researchers also found a connection between the rate at which different types of assets had their ratings downgraded or upgraded and

the different asset classes. After five years, 27.4 percent of A-rated corporate bonds, 17.8 percent of financial bonds and 33.3 percent of structured bonds were downgraded, versus only 3.3 percent of sovereign bonds and 6.1 percent of municipal bonds.

"Contrary to statements by the Big Three credit raters, our research demonstrates that credit scores are not comparable across asset classes," Hund said. "Debt from different types of issuers with the same ratings has different default rates and different patterns of ratings changes."

The study also shows that municipal and sovereign bonds have been rated more harshly and structured products more generously when compared with traditional corporate bonds. The authors found an inverse correlation between ratings standards and revenue generation among the asset classes.

"We find ratings optimism (leniency or inflation) increases in the revenue generation by asset class," the researchers wrote. "Revenues generated from structured finance products are significantly higher than those generated from corporate issuers which are, in turn, higher than those generated from sovereign issuers and municipalities."

Hund said he hopes that the study will shed new light on the current ratings system and will motivate organizations to do independent research rather than simply rely on what credit agencies are saying.

"In the past several years, some investors have depended on credit agencies to guarantee their decisions as 'safe,' and the current ratings system makes it difficult to determine which are the riskier securities," Hund said. "Ultimately, it's up to investors to know the difference, but the present system of ratings has left many with a false sense of security."

Hund said a consistent ratings system is vital to the future financial health of the United States.

"The foundation of our financial system is understanding credit risk, but we need to re-examine the credit ratings process and the ratings agency's role in that process in order to ensure that the foundation is solid for the future."

More information: papers.ssrn.com/sol3/papers.cf … ?abstract_id=1909091

Provided by Rice University

Citation: All credit ratings not created equal (2011, September 15) retrieved 27 April 2024 from https://phys.org/news/2011-09-credit-equal.html

This document is subject to copyright. Apart from any fair dealing for the purpose of private study or research, no part may be reproduced without the written permission. The content is provided for information purposes only.