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Credit Ratings Across Asset Classes: A ≡ A?

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Abstract

One aspect of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) requires federal regulators to diminish their reliance on credit ratings issued by Nationally Recognized Statistical Ratings Organizations (NRSROs). As regulators consider alternative benchmarks, we hope this study will add value by demonstrating the importance of measuring absolute risk comparably across asset classes.

Regulations drawing hard lines at „investment grade“ heretofore draw no distinction between, for example, Baa3 rated municipal bonds and Baa3 rated collateralized debt obligations (CDOs). And why should they? Moody's Investor Service (Moody's), Standard & Poor's (S&P), and Fitch Ratings (Fitch), collectively referred to as the Big 3 credit rating agencies (CRAs), report their ratings are comparable across asset classes; see the Appendix.

In this paper, we document otherwise. We employ Moody's Default and Recovery database, which includes complete ratings histories for corporate bonds, bonds issued by local and regional governments, and bonds issued by sovereign nations. We augment this data with Moody's Structured Default Risk Service database, which includes complete ratings histories for tranches of structured products, including asset backed securities (ABS), collateralized mortgage backed securities (CMBS), collateralized debt obligations (CDO), public finance (PF), and residential mortgage backed securities (RMBS).

The preliminary evidence overwhelmingly suggests that while ratings of structured products were significantly more generous (optimistic) than those assigned to corporate issues, those assigned to municipals and sovereign issuers were significantly less generous (more pessimistic). Moreover, we document a similar pattern within the broad structured finance category. Collateralized debt obligations (CDO) and residential mortgage backed securities (RMBS) are rated most generously at issuance; public finance (PF) tranches are rated least generously of all structured products.

Assertions by the Big 3 notwithstanding, evidence that rating performance varies by asset class may not surprise the informed reader. Previous literature addresses inflated credit ratings - particularly among structured finance products - and their contribution to the recent financial crisis; e.g. Coval, Jurek, and Stafford (2009). However, to our knowledge, we are the first to document comprehensively the differences in applied rating standards across the major asset classes. This is the primary contribution of this paper and we hope it will aid regulators as they reconsider appropriate risk metrics for establishing bank capital requirements and prudent investments by pension funds and insurance companies. Because these regulatory restrictions ultimately effect capital allocation, our results should be of interest to a host of market participants.

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