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BOND RATINGS, BOND YIELDS AND FINANCIAL REGULATION: SOME FINDINGS

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I. INTRODUCTION

BOND quality ratings, that is, the ratings assigned to bond issues by organizations such as Moody's Investors Service, have constituted a source of general interest to economists and practical men of affairs for some time. Of particular importance, however, have been the following three questions: (1) how are ratings determined? (2) do ratings accurately discriminate among issues on the basis of default risk; for example, do default rates vary inversely with quality ratings? (3) to what extent, if any, do ratings have an independent influence on bond yields; that is, do ratings—as opposed to the underlying economic factors that influence ratings—have an impact on the market prices of bonds? Over the past two decades, the first two questions have received considerable attention, with the result that we now know a good deal about the determinants of ratings and the relationship between ratings and bond default experience.[1]

In contrast to the progress that has been made in these areas, however, virtually no systematic empirical evidence has been assembled concerning the impact that ratings may have on yields. No doubt this void primarily reflects an inherent difficulty in devising "meaningful" tests of the relationship between ratings and yields.[2] There is, after all, a high degree of correla-

[1] Willard T. Carleton & Eugene M. Lerner, Statistical Credit Scoring of Municipal Bonds, 1 J. Money, Credit & Banking 750 (1969); Harold G. Fraine & Robert H. Mills, Effect of Defaults and Credit Deterioration on Yields of Corporate Bonds, 16 J. Finance 423 (1961); W. Braddock Hickman, Corporate Bond Quality and Investor Experience (Nat'l Bur. Econ. Res., 1958); James O. Horrigan, The Determination of Long-Term Credit Standing with Financial Ratios, 4 J. Accounting Res., Supp. at 44 (1966); Thomas J. Pogue & Robert M. Soldofsky, What's in a Bond Rating?, 4 J. Financial & Qual. Analysis 201 (1969); Richard R. West, An Alternative Approach to Predicting Corporate Bond Ratings, 8 J. Accounting Res., 118 (1970).

[2] It certainly does not reflect a lack of interest in the issue. See Roy M. Goodman, Municipal Bond Rating Testimony, 24 Financial Analysts J., No. 3, at 59 (May/June 1968); James F. Reilly, Comments on Testimony, 24 Financial Analysts J., No. 3, at 65 (May/June 1968); Brenton W. Harries, Standard & Poor's Corporation New Policy

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