New Competition and Credit Rating Quality Inconsistency in the RMBS market

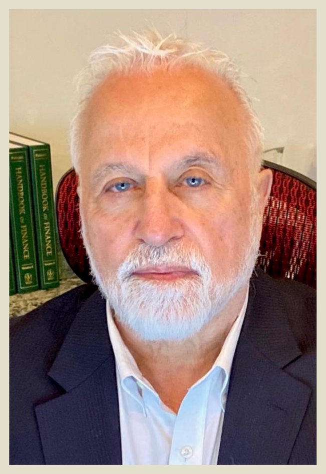
AMERICAN ECONOMIC ASSOCIATION

AFA 2022 PhD Poster Session

Vivian M. van Breemen
v.vanbreemen@my.nyenrode.nl
NYENRODE BUSINESS UNIVERSITEIT

Prof. Dennis Vink
d.vink@nyenrode.nl
NYENRODE BUSINESS UNIVERSITEIT

Prof. Frank J. Fabozzi
frank.fabozzi@edhec.edu
EDHEC BUSINESS SCHOOL



INTRODUCTION

- The credit rating market has been dominated by **three major players**: Moody's, S&P & Fitch.
- Regulators implemented rules and regulation to **stimulate competition** - specifically the entrance of smaller credit rating agencies (CRAs) - in the credit rating market.

Our objective in this paper is to investigate the **impact of competition in the credit rating market for RMBS** and shed some light on the issue of whether **competition has an impact on the quality of ratings.**

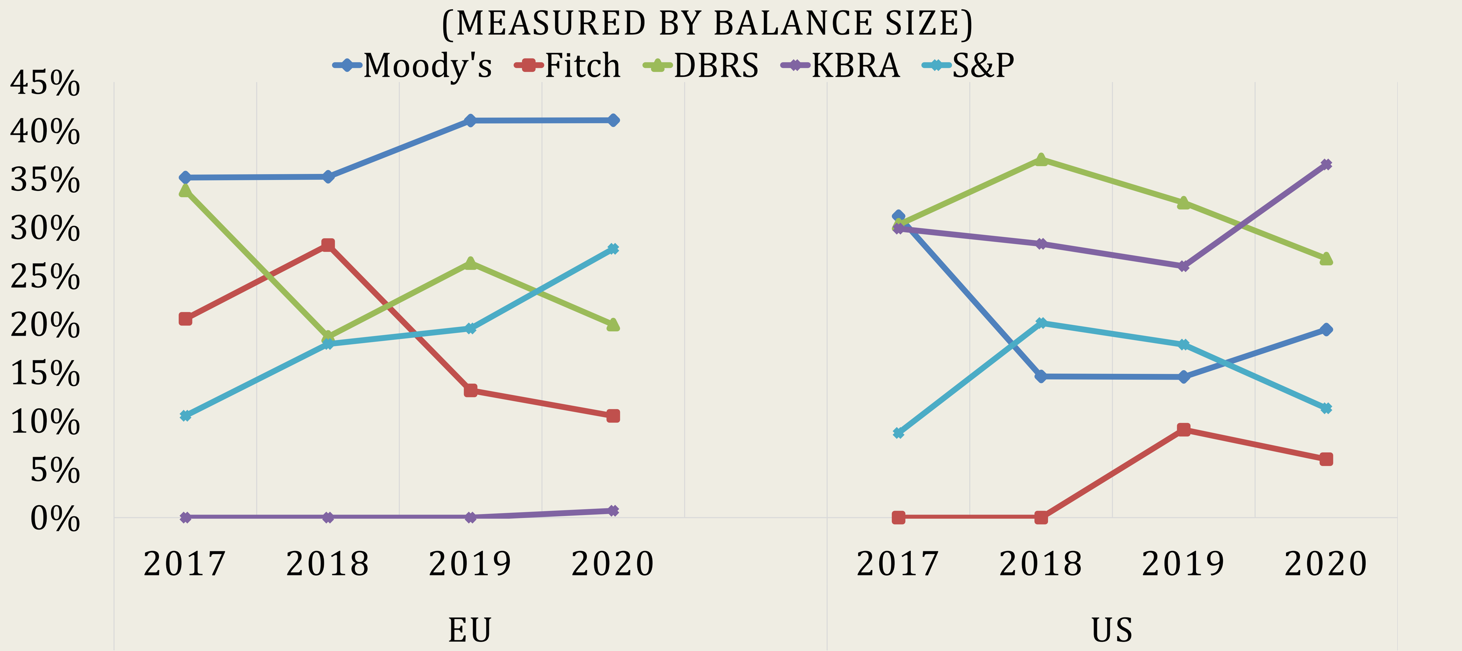
- We study the RMBS market as this is one of the few markets targeted heavily by regulation where **smaller CRAs (DBRS and KBRA)** have entered the market and gained prominent market share.
- Our study contributes to literature on competition and rating standards in the credit rating market. Work closest in spirit of our paper are those of Flynn and Ghent (2017) and Bae et al. (2019).

METHOD

- Data derived from **Bloomberg**.
- 7,719 RMBS tranches originated and sold in the EU and US market from 2017 to 2020.
- We compare the **credit ratings** of small (DBRS, KBRA) and large (Moody's, S&P, and Fitch) CRAs.
- Consistent with Becker and Milbourn (2011) and Bae et al. (2019), we calculate the market shares of CRAs in the RMBS market and used this as a measure of **competition intensity**, see figure 1.
- We apply **(ordered) logit models** to analyze if:

1. Market share of large (small) CRAs impacts the consistency of rating quality of small (large) CRAs.
2. Market share of large (small) CRAs impacts the credit rating standards of small (large) CRAs.
3. Issuer's size impacts the rating quality of small CRAs.

FIGURE 1: MARKET SHARE OF CRAS IN THE RMBS MARKET
(MEASURED BY BALANCE SIZE)



RESULTS

Competition and rating differences

- DBRS and KBRA **react differently** to movements in market share of its larger peers; KBRA provides more optimistic ratings compared to its larger peer (on average, for the same tranche), while DBRS does not.
- No significant results for tranches rated by S&P and a smaller peer.

Competition and rating standards

- Small CRAs tend to **loosen their rating standards** as a competitive strategy against Moody's, but not necessarily S&P. However, also large CRAs modify their rating standards when competition of their smaller peers is higher.

Competition and issuers' power

- Small CRAs are more likely to provide a **more lenient rating** than large CRAs, when the tranche is issued by a more powerful, large, issuer.

Detailed results

Tranche rated by	Competition intensity	Rating quality
Moody's & KBRA	Increase in market share of Moody's	Results in a more optimistic (lenient) ratings of **KBRA**, on average, for the same tranche
Moody's & Morningstar DBRS	Increase in market share of Moody's	Results in less optimistic (stricter) ratings of **DBRS**, on average, for the same tranche
	Increase in market share of DBRS	Results in less optimistic (stricter) ratings of **Moody's**, on average, for the same tranche
At least 1 rating by Morningstar DBRS	Increase in market share of Moody's	Results in an adjustment (loosening) of **DBRS's** rating standards, irrespectively whether tranche received an additional rating
Moody's & KBRA	Increase in market share of Moody's	Results in an adjustment (loosening) of **KBRA**'s rating standards
1 large CRA & 1 small CRA	Increase in market share of market share of small CRAs	Results in an adjustment (loosening) of **Moody's** and **S&P's** rating standards
At least 1 rating by KBRA	Tranche issued by larger, more powerful, issuer	Results in more optimistic (lenient) ratings of **KBRA** compared to a larger peer

CONCLUSION & POLICY IMPLICATION

- Regulators have attempted to **stimulate new entrants** into the credit rating market. Question remains whether these rules and regulations have a positive effect on the quality of ratings.
- We provide evidence that competition between large and small CRAs creates **rating quality inconsistency** in the RMBS market.

Our findings suggest that regulators should not focus merely on the number of ratings or CRAs in the market, but rather to make sure that **CRAs apply independent rating methodologies that are not negatively affected by competition in the credit rating market or issuers who put pressure on CRAs.**

KEY LITERATURE

Bae, K., Driss, H. and Roberts, G. S. (2019) Does competition affect rating quality? Evidence from Canadian corporate bonds, *Journal of Corporate Finance* 58, 605–623.

Becker, B. and Milbourn T. (2011) How did increased competition affect credit ratings? *Journal of Financial Economics* 101(3), 493–514.

Flynn, S. and Ghent, S. (2018) Competition and credit ratings after the fall, *Management Science* 64(4), 1477–1973.

He, J., Qian, J. and Strahan, P. E. (2012) Are all ratings created equal? The impact of issuer size on the pricing of mortgage-backed securities, *Journal of Finance* 67(6), 2097–2137.