New Competition and Credit Rating Quality Inconsistency in the RMBS market

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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.

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.

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.

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<tr>
<th>Tranche rated by</th>
<th>Competition intensity</th>
<th>Rating quality</th>
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<tbody>
<tr>
<td>Moody’s &amp; KBRA</td>
<td>Increase in market share of Moody’s</td>
<td>Results in a more optimistic (lenient) ratings of KBRA, on average, for the same tranche</td>
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<td>Tranche issued by larger, more powerful, issuer</td>
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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


