Losing funds, or losing face? Reputation and Accountability in the Credit Rating Industry

Assoc. Prof. Dr. Martin Angerer

Motivation:

- The Big Three (S&P, Moody's, Fitch) all rely on an issuer-pays remuneration model
- CRAs are accused of assigning inflated ratings (Becker & Milbourn, 2011; Jiang et al., 2012)
- Played a crucial role in the 2007 sub-prime mortgage crisis (Kashyap & Kovrijnykh, 2016)
- SEC states that a conflict-of-interest is "inherent" to the issuer-pays model (2008, p. 23)
- Issuer-paid CRAs argue that their credibility is at stake – "reputational capital" offers value to investors (Partnoy, 2002; Smith & Walter, 2002)
- Even before the 2007 financial crisis, some already denoted an "accountability gap" (Kerwer, 2005) and a lack institutionalization

Research Question: **"**Can endogenous <u>reputation</u> and <u>accountability</u> mechanisms overcome adverse incentives for truth-telling in an issuer-pays model?"

Method: Experimental Market Setup with paid subjects.

Experimental Design

The Rating Cycle

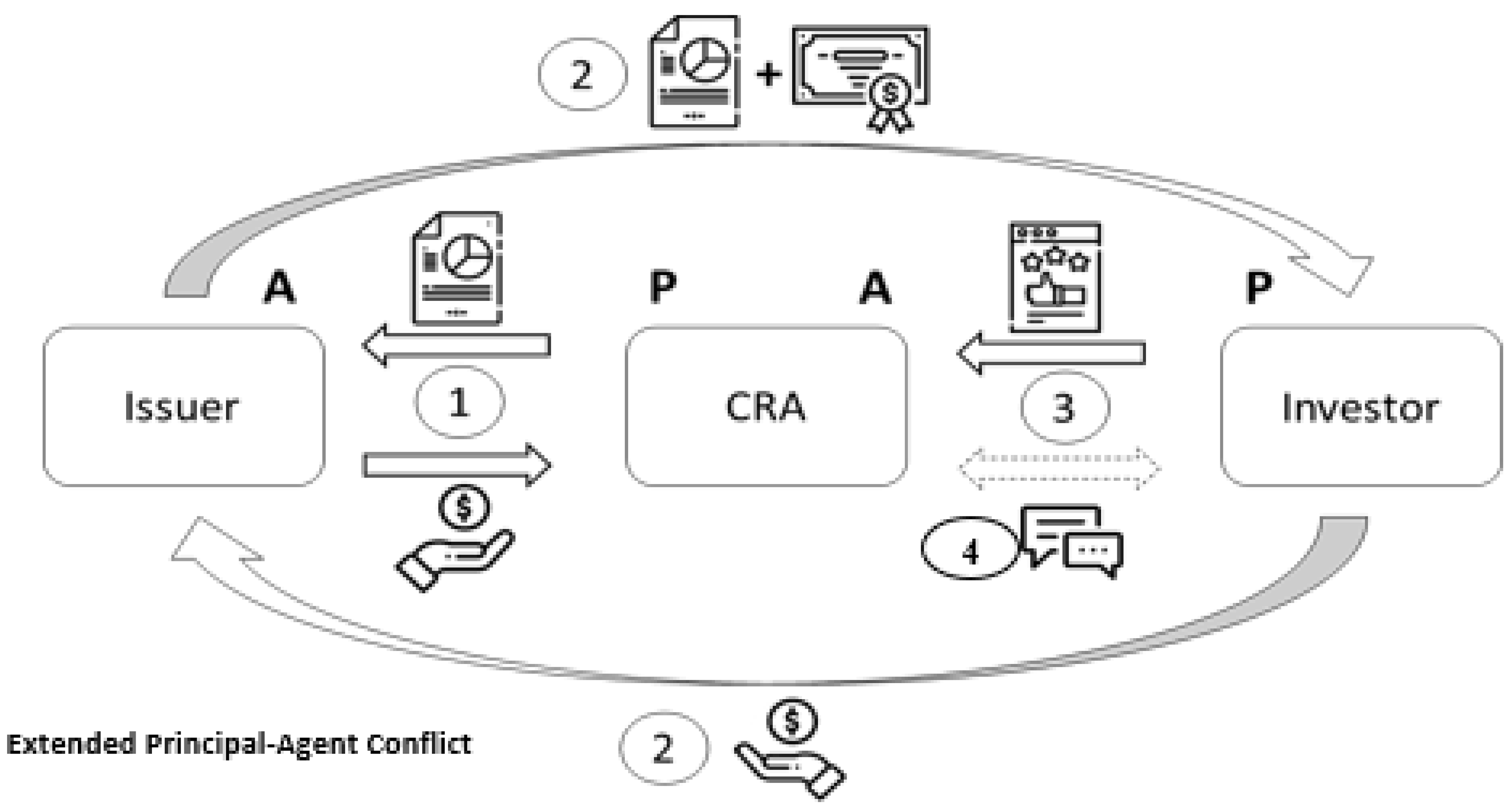

Figure 3: Extended Principal-Agent Conflict

Table 1: Comparison of Treatments

Treatment A (1+2)	Treatment B (1+2+3)	Treatment C (1+2+3+4)
• Competitive market **without further features**	• Competitive market with **feedback system** at the end of each period • Investors submit a rating	• Extension of Treatment B • All subjects **chat with each other** and then investors submit rating

Findings:

- Solely reputation concerns can ONLY REDUCE rating inflation. This is driven by the CRA's concerns about future payoffs
- Accountability concerns in conjunctions with reputation concerns effectively EXTINGUISH rating inflation.
- Rise in fees before rating inflation published reports. High fees may be causal for continued rating inflation even where a reputation mechanism is in place.
- Research need to deeper analyze the role of accountability mechanisms in the rating industry

Published as:

Angerer, M., Herrmann-Romero, M., & Szymczak, W. (2022). Losing funds or losing face? Reputation and accountability in the credit rating industry. Journal of Economic Dynamics and Control, 143, 1-32. (ABDC_2022: A*; ABS_2021: 3; VHB_3: A)

Forschungsförderungsfonds

FFF Project No fin_21_9