"Markets for Financial Information: An Economic Perspective"

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Information Production

- Markets for information underlie financial institutions, various regulatory issues
- Timely disclosures of valuation relevant information key
  - Earnings announcements
  - Trades of corporate insiders
  - Different types of analysts focus upon these
- Price declines during the Crisis heightened interest in markets for financial information
- Crisis highlights that investments are risky and that risk premium should be substantial

Information Production in the Current Environment—New Risks

- “Too big to bailout,” not just “too big to fail”
- Sovereign and bank interactions
  - within and across countries
- Can we backstop infrastructure and secondary governments?
- How should we interpret ratings of sovereigns?

Regulation FD and Credit-Rating Agencies

- Ban on selective disclosure
  - Promote fair and level playing field
  - Notable exception—ratings agencies
- Less overall information production
- Greater overall informational content to ratings changes
  - Jorion, Liu and Shi (*JFE*, 2005)

Paying for Information

- How is an informational intermediary paid?
  - Classic problem in economics
- After information provision—why pay?
  - Information already released
- Before information provision: hard to value
- Application to academic research
- User pays?
  - Difficult to exclude, *public good*
  - Manuals of ratings, but exclusion hard afterwards
- Issuer pays?
  - More later on "conflict of interest"

Getting Paid for Information?

- Wall Street uses bundled pricing model
  - User pays for access to research; soft dollars
  - Choice of investment banker, bundled with analyst coverage
- Universities use bundled pricing model—research and teaching
- Credit rating agency model—issuer pays

Paying for Asset Management

- Resolve public goods problem by charging based upon scale of holdings or even future portfolio value
- Crucial to be unable to reverse engineer holdings from disclosure (otherwise, limited incentive to pay)—frequent disclosure problematic
- Position of rivals studied—sometimes correlated with later changes in NAV

Window Dressing

- Often criticized because it misleads investors and distorts disclosure
- However, protects proprietary information
- Limits asset managers' costs from copycat investors, who don't pay

Regulatory Uses of Ratings

- Net capital standards
- Suitability requirements
  - “investment grade” assets
- Permissible holdings of money market funds
- Treasury bonds can be downgraded *to a degree* without triggering sales
  - Challenges to supply-demand structure of products
  - Pricing consequences
    - Paradox of a Treasury rally
    - Regulatory-induced sales would challenge equilibrium pricing

Credit Rating Agencies in the Cross-hairs

- Scope for mis-valuing an entire asset class rather than individual loans and idiosyncratic risk
- Potential for systemic risk as many investors relied upon these
- Outsourcing due diligence (especially to few players) is an odd basis for asset management—creating diverse signals key
  - Public goods problem and economies to scale
- Some movement towards reduced regulatory reliance in Dodd-Frank; “reliance” reinforces contribution of ratings to “systemic risk”

Treasury “Downgrade” and the Cross-hairs

- Geithner on S&P: “Terrible Judgment”
  - Do “you” blast your “referees”?
  - I try to learn from my reviewers, even when I disagree
- “Bipartisan agreement” with “in-party” variation
- Insider trading investigation of S&P officials by SEC
  - What about advance knowledge of Treasury officials?
- Who regulates whom? (Political risk)
  - Regulator ⇨ Rating Agency ⇨ Sovereign
- Loss of business from customers downgraded
  - e.g., L.A. (spillover downgrade)
  - Downgrade can either help or hurt performance of U.S. *and S&P*

Reduced Regulatory Reliance upon Ratings

- Mitigate systemic risk (mis-value an asset class)
- Avoids allowing agencies to sell regulation and amplifies conflict of interest
- Ratings for different products have different meanings (Dodd-Frank pushback)--reduce effort to engage in “regulatory arbitrage”
- Dodd-Frank takes a tighter view of ratings (more supervision) —“substitute” with competition
  - —costs additive, benefits sub-additive
- Encourages decentralized and competing due diligence (less regulatory reliance)
- Pre-Dodd-Frank, “Dead on Arrival”: Asset managers are concerned about lacking legal safe harbors

Why are Regulators Reluctant to Reduce “Reliance”?

- Scale economies (asset manager costs) and public goods of information production
- What are some alternatives?
  - Nothing
  - Supervisory determination--requires expertise
  - Outsourcing by the supervisor—separates “selection” (avoids “shopping”) from payment
  - Model-based calibrations
  - CDS pricing (market based, continuous, not scale)
    - Only available for largest instruments/players
  - Verbal descriptions; other experts (e.g., fixed-income managers??)
- Challenging—Single point of view can be wrong and leave exposure to systemic risk

Dimensional Problems in Ratings

- Probability of default vs. severity of loss
- Pricing of losses—price effects relatively large for “AAA”
  - expected losses very limited, but payoff declines occur in very bad states
- Ratings as indicators of relative value
- Unclear rankings (e.g., U.S., France, Mexico)—yields, ratings and CDS
  - however, ECB may be indirectly supporting French debt
- Stickiness of ratings (coarse grid) vs. changes in information
- Ratings inherently lag market prices
- Downgrades can be self-reinforcing (feedback loop) due to “ratings triggers” and capital standards

Issuer Pays and Conflict of Interest

- Misplaced regulatory focus--whose check (mechanical)?
- The ability to “select” as the source of conflict of interest
- Ratings shopping (Sangiorgi, Sokobin and Spatt [2009]; Skreta and Veldkamp [2009]; Bolton, Freixas and Shapiro [2009])
- Does this undercut reliability of ratings?

Sources of Conflict of Interest

- Does the ability of the issuer to “select” lead to bias either mechanically or due to responses of rating agencies? When is there ratings bias? (Sangiorgi and Spatt (2011) highlight potential opacity in ratings contacts/shoppings.)
  - Bias in ratings in opaque case—but rational model avoids winner’s curse in pricing
- Some rating agencies sell consulting advice to issuers
- Is the issuance of “unsolicited” ratings (i.e., those not purchased by the issuer) an attempt to “punish” or “extort”?
- Another “conflict”—issuer won’t purchase if rating too low (L.A. reaction after its secondary downgrade)

Why are Unsolicited Ratings Lower than Solicited Ones?

- Otherwise, no incentive to purchase rating
- Motive need not be punitive
- “Economics of Selection”—Solicited ratings have access to fine details
  - Firms for which beneficial will pay for a rating
- Are unsolicited ratings artificially low or solicited ratings artificially high due to ratings “shopping”?
- Which is the important conflict of interest?

  -Analogy to eliminating a “friction” per “Theory of the Second Best”
- Note that Treasury ratings have been “unsolicited” in sense that Treasury does not “pay”

Selection and Issuer Pays

- “Shadow” or “virtual” ratings are below published ones
  - Does the issuer purchase the “high” or the “low” rating? (The “high” one, of course)
- Import of not being rated
  - in general (Unrated is very adverse)
  - by particular agencies
- Single vs. multiple ratings at a level—single rating less favorable since potential for multiple ones at that level
- Split ratings (empirical literature—different inferences)

Winner's Curse and Credit Ratings

- Auction analogy—Should the information content of a rating being published ("purchased") be reflected in its rating?

- Should agencies adjust for "winner's curse" as only purchased when an outlier? --What are the ratings supposed to capture?
  --Winner's Curse is only a potential issue if ratings bias

- If not, should regulators adjust standards to reflect the strength of the "winner's curse"?—as in auction theory key is cross-sectional dispersion in signals

- Number of signals (agencies), techniques
  --Interpretation of maximum signals changes
  --Selection over likely ratings net of cost—tie to "notching" context

What is the Disclosure Context?

- Mandatory Disclosure of indicative ratings —No scope for selective publication and hence no ratings shopping and bias
- Transparent--Require disclosure of contacts (in practice, the meaning of a contact may be ambiguous)
- Opaque--No disclosure of contacts
- Which is fairer—transparent or opaque market?
- Sangiorgi and Spatt (2011) show opaque leads to overproduction of ratings and allows CRAs to earn rent due to issuer’s value in creating ratings

“Skin in the Game”

- Criticism of credit rating agencies
- Core principle for reforming the markets
- Yet regulators often prefer decision makers who can offer “objective” assessments
- Monoline insurers as one with “skin in the game”
  - Analogy to title insurance for title search
  - Problematic due to inability to insure aggregate risk
  - Collapsed due to poor assessment of mortgage risks
- Asset manager as an another alternative (with “skin in the game”)--fundamental conflict of interest

The “First Amendment” (U.S.)

- Credit rating agencies have had “First Amendment” protection from liability
  - Journalists offer opinions--unsolicited ratings
  - Regulators pushed against unsolicited ratings earlier in the decade
  - Do unsolicited ratings affect the environment for application of the First Amendment?
  - Dodd-Frank pulled back on liability, but SEC “blinked” after threat to withdraw ability to use ratings in securitization prospectuses

Rating agency vs. analysts?

- First Amendment and liability
  - “financial publishers”
- Which do we rely upon for regulatory purposes such as net capital standards?
- Analysts as a target of Reg FD, NRSROs exempt

Reputation

- Economists viewed rating agencies as showing how reputation disciplines poor decisions
- Perhaps more important than liability
- Extraordinary loss of agency reputation in last few years; theory suggests that punishment is a loss of profits or exit—arguably theory was not very successful
- Dominant agencies from earlier still dominate though more scope for quantitative assessments
- Capital markets still react to ratings (“paradox of ratings”)
  - Has the reaction declined?
  - Link between past performance, future market share

Reputation and “the Downgrade”

- Egan-Jones downgrade received only slight notice—it’s reputation in this space is modest (received NRSRO designation in new framework designed to promote entry)
- Questions about whether S&P reputational concern from “crisis” motivated downgrade
- Impacts on S&P’s business
- WSJ (news headline):
  - “Obama and S&P Vie for Credibility”

Contrast to Auditing

- Liability is more central in auditing
- Arthur Anderson faced “death” penalty, though conviction was overturned; very costly to society
- Collapse of Arthur Anderson led to change from Big Five to Big Four
- Auditor independence rules greatly restrict further potential competition
- Change in industrial organization influences market power, but also potential punishment
  - 2005 KPMG tax-advice (deferred prosecution) settlement may have reflected these constraints

Entry Barriers

- Apparently considerable barriers for large global auditors and NRSROs
- No major player has replaced Arthur Andersen; major rating agencies don't have a significant new competitor
- New NRSROs due to modified framework to end "chicken and egg" problem, but relatively specialized roles—Previously, could the market "recognize" an agency without the designation?

Credit Rating Agency Issues

- Encourage or discourage "unsolicited ratings"?
  - What's the problem?
- Transparent Inputs? Records? Models? Contacts?
- Fair disclosure (FD)
- Should we reduce reliance on ratings? (Dodd-Frank) How comfortable are regulators with a more open playing field? Do we "need" a substitute approach?
- How can we encourage independent information production by asset managers? Are they relying excessively on ratings given their fiduciary duties?
- How valuable is "skin in the game"?
- Payment model; conflict of interest
- Systemic risk—Is reliance on rating central to this?
- Liability (Dodd-Frank; 1st amend.), reputation and entry