Securitization Rating Performance and Agency Incentives

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Summary

Securitizations involve the sale of asset portfolios to bankruptcy-remote special purpose vehicles, which are funded by investors of different seniorities (tranches). Based on the nature of the securitized asset portfolios, important transaction types include asset-backed securities (ABSs), collateralized debt obligations (CDOs), home equity loan-backed securities (HELs) and mortgage-backed securities (MBSs). Securitizations are rated by Credit Rating Agencies (CRAs) based on quantitative models. Examples are VECTOR from Fitch rating agency, CDOROM from Moody's rating agency and CDO Evaluator from Standard and Poor's rating agency.

The Global Financial Crisis led to an unprecedented and unexpected increase of impairment rates for securitizations. The disappointment of investors resulted in the criticism of models applied by CRAs. A similar critique was ventured after the South East Asian Crisis of 1997 in relation to corporate bond issuer and bond issue credit ratings. This paper looks for explanations of the unprecedented and unexpected increase of impairment rates and analyzes cross-sectional and time-series characteristics of credit rating agency ratings, implied impairment rate estimates and realized impairment rates of asset portfolio securitizations.

This paper identifies two gaps in the existing literature. Firstly, important contributions analyze rating migrations with regard to informativeness of securitization credit ratings reflected by rating changes. This paper extends the literature by analyzing the ability of credit ratings to reflect impairment risk and collects a unique database of 13,072 impairment events.

Secondly, this paper finds new evidence on incentive miss-alignments and extends the above theoretical literature empirically. The paper is first of its kind to show that CRAs collect the majority of fee revenue at origination. Following this observation, the paper compares ratings at origination with ratings at monitoring years as well as total securitization volume at origination. The paper finds that ratings under-reflect risk in periods when CRA fee revenue is high.

Consequences from the findings of the papers relate to establishment of rating standards for CRA's and higher transparency of employed approaches, models and parameters, along with more prudential supervision. The 'paid-by-originator' approach may be a source for misaligned incentives. This may be addressed i) ex ante by switching to a 'paid-by-investors' approach or ii) ex post by a tax for risk under-representation.