Discussion of "Precision of Ratings" by Kartasheva and Yilmaz

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The Paper

- Issuer can have three types v_i, $i \in \{1, 2, 3\}$. Rating agency commits to a revelation scheme and a fee, both of which are observable.
- Issuer can purchase a rating, which will be issued automatically. Investors observe ratings and pay price charged by issuer.
- Issuer's outside option is δv_i
- Some investors are informed and many are uninformed:
  - Probability q that an uninformed investor misses out on an issue that informed are interested in.
  - Uninformed investors are still marginal investors, so their valuation determines the price.

Results

- CRA sets willingness to pay of issuers equal. Can do this through manipulating precision (and ratings inflation).
- When $q = 1$:
  - CRA extracts full surplus, and is indifferent between rating 2 or 3 issuer types.
  - Precision of ratings increases with δ.
  - For $\delta > \bar{\delta}$, there is ratings inflation.
- When $q < 1$:
  - CRA prefers to rate 2 issuer types than 3 issuer types (underpricing less)
  - For high q, 2 issuers solicit ratings, for low q, only 1 issuer solicits.
  - For $\delta > \bar{\delta}$, there is ratings inflation. $\bar{\delta}$ increases with q.
- This paper is very timely and interesting.

Insights into Ratings Inflation

	v_3	v_2	v_1
s_3	1	$1-p$	0
s_2	0	p	0
s_1	0	0	1

	v_3	v_2	v_1
s_3	z	0	0
s_2	$1-z$	1	0
s_1	0	0	1

- Not all information structures that lead to same expected value for an issuer are equivalent
- This is because the issuer learns ther rating/signal before it prices the investment $\longrightarrow$ there is an ex-post IR constraint as well as ex-ante IR constraint.
- If $U_{s_i} < \delta v_j$ for any signal $s_i \in \{s_1, s_2, s_3\}$, issuer won't sell with that rating. This leads to ratings inflation.

Implications 1

Why did ratings do poorly for structured finance?
$\longrightarrow$ Answers from literature: (lack of) reputational discipline, complexity, regulatory arbitrage

- **Reputation**: not in the model.
  - Incentives for CRA come from ability to commit to precision.
  - Where does commitment come from? May be reasonable when CRA can extract full surplus.
- **Complexity**: fraction of uninformed investors?
  - Proposition 10: More uninformed investors $\longrightarrow q \uparrow \longrightarrow \bar{\delta} \uparrow \longrightarrow$ less ratings inflation
  - unless more complexity means larger winner's curse for same amount of uninformed investors (not modeled)

Implications 2: Exclusion

- What does the exclusion of issuer types correspond to empirically?
  - Moody's rates almost all issuers of corporate bonds, including issuers who don't pay (unsolicited ratings).
    - What would unsolicited ratings imply here? Change outside option of issuer, relaxing ex-ante and ex-post IR.
  - Does anyone think that CRAs excluded risky issuers in structured finance?
    - Lack of ratings by a certain CRA probably due to shopping.

Implications 3: Competition and Precision

- Lizzeri (1999) shows that competition can lead to full information revelation $\longrightarrow$ competition is important.
- Becker and Milbourn (2011) show that the entry of Fitch led to worse ratings quality for S&P and Moody's.
- Xia (2012) shows that the entry of Egan-Jones (investor-pay) led to better ratings quality for S&P when there is downgrading pressure.

Implications 4: Policy

- Should we take Dodd-Frank on CRAs seriously?
  - Higher standard of liability for CRAs has not been enforced, as an initial attempt caused CRAs to pull their ratings from asset-backed securities, freezing the market.
  - The SEC decided, in response, to delay implementation for further study, and there is discussion about eliminating the requirement (see Jessica Holzer, "House Panel Votes to Free Raters From ABS Liability," Wall Street Journal Online, Jul 20, 2011).
- Rating standardization: how would that be formulated and monitored?

Screening

- Can the CRA use screening contracts to extract more surplus when q<1?
  - e.g. (l_3, ϕ_3), (l_2, ϕ_2), and (l_1, ϕ_1)
  - This is not useful for $q = 1$, as full surplus is extracted anyway.
  - CRA is restricted to uniform pricing - fees are set to attract marginal type

Pagano and Volpin (2012)

- Here, increased precision reduces winner's curse.
- In Pagano and Volpin (2012), increased precision worsens winner's curse because investors vary in their ability to understand precision.
    - They also look at a secondary market, where initial opacity can cause sophisticated to invest in information, causing a tradeoff in adverse selection between the primary and secondary market.