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Do asset backed securities ratings matter on average?☆

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ABSTRACT

This paper assesses the impact of asset backed ratings on the Merrill Lynch US Asset Backed Securities and Commercial Mortgage Backed Securities Index (CABs index) over a period January 1998 through to February 2010. In particular, we examine the relationship between ratings changes of the asset backed securities and the CABS index return. We further investigate how macroeconomic variables affect the relation between change in ratings and the CABS index return. We find that on their own, ratings of assets backed securities do matter to the CABS index return. However, controlling for economic factors appears to reduce the impact of the ratings changes on the CABS index return.

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1. Introduction

The subprime crisis has demonstrated investors' limited understanding towards the complexities of asset backed securities and the underlying risks that the ratings of these instruments entail, leading to an undue reliance placed on the securities ratings for their investment decisions. The central theme of structured finance lies in the ability of financial institutions to securitise financial assets, and thereby, creating tradable instruments of varying degrees of subordination that have different risk-return profiles tailored to the specific risk appetites of investors. Structured finance products serve as an important avenue of credit risk transfer for financial institutions and also allow for greater capital efficiency. A conventional structured finance arrangement is an Asset-Backed Security (ABS), whereby a portfolio of income-producing assets such as loans are bundled and sold to investors in tranches with different tiers of priority in receiving cash flows as well as promised returns. The ratings of asset backed securities have been highly criticised and the ratings agencies are under scrutiny for having given investment-grade ratings to asset backed securities based on risky subprime mortgage loans. These high ratings enabled these securities to be sold to investors, thereby financing the US housing boom, see for example the Financial Crisis Inquiry Report (2011).

However, credit ratings agencies are not the only culprit for the current financial market turmoil. Certainly, there are other financial market participants to whom blame is also attributable as regard the crisis. In spite of criticisms, the agencies still retain some weight in today's financial markets and have demonstrated that they are back to work given investors have been following their views carefully on sovereign debt in places like Greece, Japan and Italy. The existing literature on credit ratings does not seem to do much justice to the role played by the rating agencies. Rating agencies seem to be always criticised, except for a few studies. For example, Boot et al. (2006) highlight a fundamental disagreement on whether ratings play a meaningful role and have real informational value. However, they provide support for the existence and role of the rating agencies in that they argue that credit ratings can serve as "focal points". Although investors blame that the rating agencies are too slow in adjusting their ratings to changes, there exists a possible explanation for the "presumably slow re-rating" by the agencies. That is, in assessing rating, the agencies use the through-the-cycle methodology, which intends to measure default risk over long investments horizons and to respond to only changes in the permanent component of credit quality. In fact, studies document that rating agencies do not generally exhibit excess sensitivity to the business cycles; see for example, Amato and Furfine (2004). Altman and Rijken (2005) show further support of the agencies by confirming that the exclusive focus of agencies is on the permanent component of credit quality. Stolper (2009) also provides support for the rating agencies. He empirically shows that the threat of a reputational loss presents a very strong incentive for the credit ratings agencies to assign a correct rating. During the past ten years, a number of researchers acknowledge the criticisms made on the rating agencies, but their conclusions nevertheless underline the continuing importance of the credit rating agencies. As such, one of the motivations of this paper is to test whether the criticisms of the rating agencies are justified, in particular over the crisis period and re-visit the role of the agencies in the financial market.

Given the controversy on the rating agencies, we are motivated to assess whether the reliance placed by investors on credit ratings is justified. We do so by focusing on the structured finance products market, where rating agencies are mostly blamed during the sub-prime crisis. Specifically, this paper assesses the impact of asset backed ratings on the Merrill Lynch US Asset Backed Securities and Commercial Mortgage Backed Securities Index (CABs index) over a period January 1998 through to February 2010. In addition to the information content of credit ratings, we examine how macroeconomic variables affect the relation between change in ratings and the CABS index return.

While there has been a rich vein of research in credit ratings covering a wide range of issues, including bond ratings, sovereign ratings, corporate ratings, the academic research is relatively silent with regards to ratings of structured finance products. However, the phenomenal growth of the structured finance sector has not escaped the attention of regulators and industry practitioners, who have published anecdotal studies and working papers in this area. For example, Carron et al. (2003) and the Committee on the Global Financial System (2005) present comprehensive overviews of the role of ratings in structured finance and also review the analytical methodologies and issuer selectivity among the credit rating agencies. Ammer and Clinton (2004) also contribute to the literature by documenting