Accepted Manuscript

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PII: S0378-4266(15)00087-4
DOI: http://dx.doi.org/10.1016/j.jbankfin.2015.03.010
Reference: JBF 4695

To appear in: *Journal of Banking & Finance*

Received Date: 16 January 2014
Accepted Date: 28 March 2015

Please cite this article as: Fischer, T., Market Structure and Rating Strategies in Credit Rating Markets - A Dynamic Model with Matching of Heterogeneous Bond Issuers and Rating Agencies, *Journal of Banking & Finance* (2015), doi: http://dx.doi.org/10.1016/j.jbankfin.2015.03.010

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Abstract

This paper investigates the impact of rating agencies in a market with asymmetric information. In particular, the role of credit rating agencies as an intermediary between investors and bond issuers is discussed. We model this setting in a dynamic framework in which both rating agencies and bond issuers are of heterogeneous quality. Rating agencies can apply costly research technology to reveal the fundamental nature of bond issuers and engage in rating smoothing. We show that rating smoothing can compensate for low research quality, even though it is accompanied by a quality deterioration in the rating market and market clustering. Moreover, low-quality bond issuers have a general tendency to match with low-quality rating agencies. If investors place a strong emphasis on the reputation of rating agencies, rating markets also tend to be strongly clustered.

JEL classification: G24 - D83 - C63 - L11 - L14

Keywords: rating agencies, rating smoothing, market structure

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