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Abstract

We analyze a certification intermediary's incentives to distort ratings in a model with a monopolistic profit maximizing certification intermediary, a continuum of heterogeneous sellers, and a competitive market of risk-neutral buyers. The value of a seller's good is known to the seller and observable by the certifier, but not by buyers. Sellers can choose to get a rating. The certification intermediary can reveal a signal of arbitrary precision about the quality of the good. In contrast to the existing literature, we allow aggregate uncertainty. As in the existing literature, one rating class is optimal. However, the certification intermediary does not generally choose a socially optimal cutoff: the certifier is more likely to be too lenient if the distribution of aggregate uncertainty has a lower mean, a higher variance, and is more left skewed. It is more likely to be too strict if the opposite holds.

Keywords: Certification intermediaries, rating agencies, aggregate uncertainty, financial crisis

JEL-Classification: C72, D42, D82

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