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## **Performance-Based Payment Scheme to Hedge Against Credit Rating Inflation**

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### **Abstract**

Credit rating inflation is a prevalent issue in financial markets. Existing studies have attributed a cause of inflated rating to credit rating agencies' biased conduct for their own benefits. In this paper, we propose a performance-based payment mechanism which can be used to align the incentives between the issuers seeking ratings and the rating agencies. Under the proposed mechanism, the issuer who brings in a risky project for rating can specify the level of information to be obtained by the rating agency; whereas, the rating agency can choose whether to report the acquired information truthfully. After the rating has been announced and the investment decision has been made, the project return is shared between the issuer and the rating agency according to the predetermined terms. We show that as long as the issuer carries a

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