“Markets for Financial Information”

by

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Information Production

• Markets for information underlie financial institutions, various regulatory issues
• Timely disclosures of valuation relevant information key
  – Earnings announcements
  – Trades of corporate insiders
  – Different types of analysts focus upon these
• Price declines during the Crisis heightened interest in markets for financial information
Regulation FD and Credit-Rating Agencies

- Ban on selective disclosure
  - Promote fair and level playing field
  - Notable exception—ratings agencies
- Less overall information production
- Greater overall content to ratings changes
  - Jorion, Liu and Shi (*JFE*, 2005)
Paying for Information

• How is an informational intermediary paid?
  – Classic problem in economics
• After information provision—why pay?
  – Information already released
• Before information provision: hard to value
• User pays?
  – Difficult to exclude, public good
  – Manuals of ratings, but exclusion hard afterwards
• Issuer pays?
Getting Paid for Information?

• Wall Street uses bundled pricing model
  – User pays for access to research; soft dollars
  – Choice of investment banker, bundled with analyst coverage

• Credit rating agency model—issuer pays
Paying for Asset Management

- Resolve public goods problem by charging based upon scale of holdings or even future portfolio value
- Crucial to be unable to reverse engineer holdings from disclosure (otherwise, limited incentive to pay)—frequent disclosure problematic
- Position of rivals studied—sometimes correlated with later changes in NAV
Window Dressing

- Often criticized because it misleads investors and distorts disclosure
- Protects proprietary information
- Limits asset managers’ costs from copycat investors, who don’t pay
Credit Rating Agencies in the Cross-hairs

- Scope for mis-valuing an entire asset class rather than individual loans and idiosyncratic risk
- Potential for systemic risk as many investors relied upon these
- Outsourcing due diligence (especially to few players) is an odd basis for asset management—creating diverse signals
  - Public good problem and economies to scale
- Limited moves toward reduced regulatory reliance on ratings; “reliance” reinforces contribution of ratings to “systemic risk”
Regulatory Uses of Ratings

• Net capital standards
• Suitability requirements
  – “investment grade” assets
• Permissible holdings of money market funds
Reduced Regulatory Reliance upon Ratings

- Mitigate systemic risk (mis-value an asset class)

- Avoids allowing agencies to sell regulation and amplifies conflict of interest

- Ratings for different products have different meanings—reduce effort to engage in “regulatory arbitrage”

- Encourages decentralized and competing due diligence

- In past, “Dead on Arrival”: Asset managers are concerned about lacking legal safe harbors
Why are Regulators Reluctant to Reduce “Reliance”? 

• Scale economies (asset manager costs) and public goods of information production 

• What are some alternatives? 
  – Nothing 
  – Supervisory determination—requires expertise 
  – Outsourcing by the supervisor—separates “selection” (avoids “shopping”) from payment 
  – Model-based calibrations 
  – CDS pricing (market based, continuous, not scale)  
    • Only available for largest players
Dimensional Problems in Ratings

- Probability of default vs. severity of loss
- Pricing of losses—price effects relatively large for “AAA”
  - expected losses very limited, but payoff declines occur in very bad states
- Ratings as indicators of relative value
- Stickiness of ratings (coarse grid) vs. changes in information
- Ratings inherently lag market prices
- Downgrades can be self-reinforcing due to “ratings triggers” and capital standards
Issuer Pays and Conflict of Interest

- Misplaced regulatory focus--whose check (mechanically)?
- The ability to select as the source of conflict of interest
- Ratings shopping (Sangiorgi, Sokobin and Spatt [2009]; Skreta and Veldkamp [2009])
- Does this undercut reliability of ratings?
Sources of Conflict of Interest

• Does the ability of the issuer to “select” lead to bias either mechanically or due to responses of rating agencies?

• Some rating agencies sell consulting advice to issuers

• Is the issuance of “unsolicited” ratings (i.e., those not purchased by the issuer) an attempt to “punish” or “extort”?
Why are Unsolicited Ratings Lower than Solicited Ones?

- Otherwise, no incentive to purchase rating
- Motive need not be punitive
- “Economics of Selection”—Solicited ratings have access to fine details
  - Firms for which beneficial will pay for a rating
- Are unsolicited ratings artificially low or solicited ratings artificially high due to ratings “shopping”?
- What is the important conflict of interest?
  - Analogy to eliminating a “friction” per “Theory of the Second Best”
The “First Amendment”

• Credit rating agencies have “First Amendment” protection from liability
  – Journalists provide opinions, as in unsolicited ratings
  – Regulators pushed against unsolicited ratings earlier in the decade
  – Do unsolicited ratings affect the environment for application of the First Amendment?
Rating agency vs. analysts?

• First Amendment and liability
  – “financial publishers”
• Which do we rely upon for regulatory purposes such as net capital standards?
• Analysts as a target of Reg FD, NRSROs exempt
Selection and Issuer Pays

• “Shadow” or “virtual” ratings are below published ones
  – Does the issuer purchase the “high” or the “low” rating?

• Import of not being rated
  – in general
  – by particular agencies

• Single vs. multiple ratings at a level

• Split ratings (empirical literature—different inferences)
Winner’s Curse and Credit Ratings

• Auction analogy—Should the information content of a rating being published (“purchased”) be reflected in its rating?

• Should agencies adjust for “winner’s curse” as only purchased when an outlier? --What are the ratings supposed to capture?  
  --Winner’s Curse is only an issue if ratings bias

• If not, should regulators adjust standards to reflect the strength of the “winner’s curse”?—as in auction theory key is cross-sectional dispersion in signals

• Number of signals (agencies), techniques
  --Interpretation of maximum signals changes
  --Selection over likely ratings net of cost—tie to “notching” context
What is the Disclosure Context?

• Mandatory Disclosure of indicative ratings —No scope for selective publication and hence no ratings shopping and bias

• Transparent--Require disclosure of contacts (in practice, the meaning of a contact may be ambiguous)

• Opaque--No disclosure of contacts

• Which is fairer—transparent or opaque market?
“Skin in the Game”

• Core principle for reforming the markets
• Criticism of credit rating agencies
• Yet regulators often prefer decision makers who can offer “objective” assessments
• Monoline insurers as an alternative
  – Analogy to title insurance for title search
  – Problematic due to inability to insure aggregate risk
Reputation

• Economists viewed rating agencies as showing how reputation disciplines poor decisions
• Perhaps more important than liability
• Extraordinary loss of agency reputation in last few years; theory suggests that punishment is a loss of profits or exit—theory was not very successful
• Dominant agencies from earlier still dominate though more scope for quantitative assessments
• Capital markets still react to ratings (“paradox of ratings”)
  – Has the reaction declined?
  – Link between past performance, future market share
Contrast to Auditing

- Liability is more central in auditing
- Arthur Anderson faced “death” penalty, though conviction was overturned; very costly to society
- Collapse of Arthur Anderson led to change from Big Five to Big Four
- Auditor independence rules greatly restrict further potential competition
- Change in industrial organization influences market power, but also potential punishment
  - 2005 KPMG tax-advice (deferred prosecution) settlement may have reflected these constraints
Entry Barriers

• Apparently considerable barriers for large global auditors and NRSROs
• No major player has replaced Arthur Andersen; major rating agencies don’t have a significant new competitor
• New NRSROs due to modified framework to end “chicken and egg” problem, but relatively specialized roles—Previously, could the market “recognize” an agency without the designation?
Credit Rating Agency Issues

• Encourage or discourage “unsolicited ratings”?  
  – What’s the problem?  
• Fair disclosure  
• Should we reduce reliance on ratings? How comfortable are regulators with a more open playing field? Do we need a substitute?  
• How can we encourage independent information production by asset managers? Are they relying excessively on ratings given their fiduciary duties?  
• How valuable is “skin in the game”?  
• Payment model; conflict of interest  
• Systemic risk  
• Liability, reputation and entry