“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?
- What should be transparent? Inputs? Records? Models? Contacts?
- 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