Absolute or Relative ? What standards do rating agencies follow?

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Absolute or Relative ? What standards do rating agencies follow?[2]

In this paper we study the rating standards followed by the credit rating firms in the US. There are only two papers that discuss this question (Blume, Lim and MacKinlay (1998), Doherty and Phillips (2002)). Both assume that the credit rating firms have absolute rating standards and that the standards have become more stringent over time. In the light of the Basel Capital Accord and the credit ratings entering pricing models this question has become important. So we plan to revisit this question and build upon the previous literature in the following manner: (1) Use market based measures of default risk for a firm rather than the accounting based measures of credit risk used in earlier papers; and (2) Study whether the ratings are benchmarked to some risk standard.

In the first part of the paper we review both the theoretical underpinnings of the rationale for existence of the credit rating firms and the empirical evidence related to credit ratings. We draw not only upon the finance literature but also upon general management literature as well (see Nerkar and Paruchuri (2005); Paruchuri *et al* (2006)). By and large, the empirical literature focuses on the information content of bond ratings (Grier and Katz [1976], Hand *et al*. [1992]), prediction of bond ratings (Fisher [1959], Altman [1968], Ederington [1985]) and the default experience of bond ratings in different rating categories (Lucas and Lonski [1992], Hu and Cantor [2003]). In this part we shall also provide the overview of the credit rating industry.

In the second part we will first introduce the market based measure of credit risk as given by the Merton [1974] model of default, which measures the default risk of a firm

[2] The paper is based on the unpublished dissertation of the same title by the corresponding author, submitted to Georgia State University, Atlanta, GA in 2005.

as a whole rather than an individual bond issue. Next, we will use the model to estimate the probabilities of default.

The econometric model is introduced in the third section. In this part the rating of a firm will be regressed against the probability of default calculated in the second section. We test whether the credit rating agencies follow a relative or an absolute rating standard.

The data sources are the publicly available databases CRSP, Compustat, FISD and the NBER website. The data will cover the period 1986 – 2000.

The final section of the paper comprises our findings and conclusion. The limitations of the study and the future direction of research shall also be discussed in this section.

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