Discussion

FDIC- JFSR Conference

Credit Ratings in Lending and Regulation

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Discussion by
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Two Papers

- Risk Management and Ratings segmentation in credit markets by Rodano, Serrano-Velarde, Tarantino
- The removal of credit ratings from capital regulation by Hanley & Nikolova

Motivation

- Credit ratings are important in financial markets
- But do they do more harm than good?
- They were often seemingly wrong (financial crisis), tend to lag the market and can lead to
  - Increases in systemic risk (HN)
  - Risk management and segmentation in credit ratings can have adverse real consequences (RVT)

Motivation

- How credit ratings affect the market and firms raises clearly important questions
- Not just for academicians but regulators, banks.
- These papers try to answer these questions by taking advantage of
  - Great data
  - Great experimental setting

Rodano, Serrano-Velarde, Tarantino

- How does bank's risk management policies affect credit conditions?
- Uses Italian lending market for SME
- Credit rating is purchased from external agency
- Rating is a continuous variables but ratings are given in discrete "buckets" i.e., there is segmentation of into rating categories.
- Paper looks at firms just around the cutoff to see if discontinuous lending applied to firms and if there are differences in real outcomes.

Rodano, Serrano-Velarde, Tarantino

- Ratings segmentation produces large differences in the credit conditions to otherwise identical firms.
- 2 distinct pricing regimes:
  - 2004-2007 in expansionary phase, same amount of lending but up to 10% of higher interest rates
  - 2008-2009 in contractionary phase upto 60% less credit
  - 2019-2011 again see price discrimination upto 20% of interest rates.

Rodano, Serrano-Velarde, Tarantino

- Further find differences in credit conditions and firms' real decisions, these firms have reduced investment, employment etc so experience a contraction.
- Conclude risk management policies matter.

Rodano, Serrano-Velarde, Tarantino

- Dataset is loan level dataset covering the universe of bank funding contracts for SMEs in Italy.
- Banks purchase these ratings
- But do banks create their own ratings?
- Iyer et al find in Prosper (with less sophisticated investors than banks) investors can back out the true rating within buckets. Can’t banks?

Rodano, Serrano-Velarde, Tarantino

- Can improve institutional detail on how score is created, e.g.,
  - Is soft information included? Could be manipulated then.
  - Do these firms have prior lending relationships with banks? This should make a difference.

Rodano, Serrano-Velarde, Tarantino

- Differences in pricing and quantity of credit in otherwise “comparable” firms.
- Are firms really comparable? A lot is done around characteristics
- Most convincing measure would be to examine if default rates are similar – they should be for truly comparable firms.

Rodano, Serrano-Velarde, Tarantino

- More honing of the economic interpretation needed and takeaway for policy needed.
- Is this really a result of risk management or a result of having “buckets’ or segmentation?
- You could have a risk management system that takes the continuous variable into account.

Hanley and Nikolova

- Nice setting: Takes advantage of change in regime
- National Association of Insurance Commissioners (NAIC) no longer rely on credit ratings to determine capital and accounting treatment of RMBS and CMBS.
  - To avoid double whammy on insurers
  - Increases in required capital with downgrades
  - Need to recognize expected losses through write-downs.

  => Increases selling pressure

Hanley and Nikolova

- NAIC removes credit rating as measure of expected loss and substituted potentially more precise numerical expected loss estimates.
  - Hope - if this valuation is more precise than ratings than won't have the same adverse effects (but is it more precise?)
  - NAIC removes double penalty of downgrade by recognizing the security's expected loss is relative to is amortized par value. So if you hold security at value lower than par then using credit ratings can overstate the capital need.
  - Authors estimate that this change in methodology saved insurers $4.8 billion in regulatory capital.

Hanley and Nikolova

- What was the effect of these changes?
- Authors find probability of selling downgraded RMBS and CMNS reduces
- Similar effect on probability of gains trading corporate bonds.
- Further find that issuers buy RMBS/CMBS in secondary market below par and hold lower capital – helps alleviate selling pressure by creating buyers and treating them fairly.

=> Authors argue that this alleviates systemic risk due to asset liquidation.

Hanley and Nikolova

- Some questions on economic interpretation and takeaways for policy.
- Is this because of the (non) use of credit ratings or because of the kind of new valuation used?
- What is the “right” measure of risk?
- Could you have continuous credit rating instead (relates to first paper)?
- Could credit ratings be used in a different (equivalent) manner? E.g., relate expected loss based on credit ratings to the price at which the security was bought.

Hanley and Nikolova

- Could do this by regulating credit ratings "sensibly', rather than blindly.
- Downside – Reaching for yield. Is the penalty for holding non-investment grade securities adequate?

Hanley and Nikolova

- Results suggest if you can game regulation you will!
- Broader implications – do not use credit ratings blindly
- But do we really need new valuation methodology? Do we have evidence it is better? Can credit ratings be used in a similar, more nuanced, manner as the new methodology?

Conclusion

- Both papers deal with very interesting questions.
- Great data and experiment design
- Interpretation needs sharpening in terms of economic takeaways.
- I enjoyed reading these papers!