

Credit Rating Gamma

The role of ratings agencies has been placed under intense scrutiny in the wake of the 2008 credit crisis.

Clearly the ratings agencies have failed in one glaring respect. The creditworthiness of a borrower is tied not only to its solvency but to its ability to generate cash flow to repay, as well as its ability to raise debt financing. The publishing of a credit rating therefore must impact the borrower's ability to further borrow. There is inherent gamma in the very act of issuing a rating. An upgrade or a favourable rating improves the borrower's ability to raise debt while a downgrade or an unfavourable rating impairs the borrower's ability to raise debt.

It is not immediately clear how to model and estimate the convexity of this phenomenon. I am sure there is sufficient data to model this phenomenon econometrically. How good are the estimates? No worse than the rating that a ratings agency could issue on a complex CDO tranche.

This is a more deep rooted problem than one about ratings agencies. It is a problem overlooked by regulators and market participants alike; that their very actions change the nature of the risks they attempt to quantify, analyse and manage.