Did investors outsource their risk analysis to rating agencies? Evidence from ABS-CDOs

Thomas Mählmann *

Chair of Banking and Finance, Catholic University of Eichstaett-Ingolstadt, Auf der Schanz 49, 85049 Ingolstadt, Germany

A R T I C L E   I N F O

Article history:
Received 5 July 2011
Accepted 24 December 2011
Available online xxxx

JEL classification:
G21
G28

Keywords:
Asset-backed security
Credit rating
Collateralized debt obligation
Yield spread

A B S T R A C T

Based on a sample of 3254 floating rate tranches from 617 ABS-CDOs (collateralized debt obligations backed by asset-backed securities), this paper tests the “rating overdependence” hypothesis – i.e., that ratings of structured products are a sufficient statistic (in terms of predicting future credit performance) for yield spreads at origination. The paper’s findings are fourfold. First, yield spreads at issuance predict future performance of ABS-CDO tranches even after controlling for the information contained in ratings. Second, the ability of yield spreads to predict future performance, however, is driven exclusively by ratings below AAA (and, to a lesser extent, also by the lowest priority AAA tranches), whereas spreads of super senior AAA tranches show no information content. Third, the predictive ability of yield spreads is lower for tranches from later vintages and for tranches from deals with more complex collateral pools. Fourth, the conditional correlation between ratings and spreads, in turn, is increasing in time and higher for tranches from complex deals. In sum, the evidence indicates that investors in (especially AAA) tranches from later and more complex deals have avoided performing costly due diligence on the securities they bought.

© 2012 Elsevier B.V. All rights reserved.

1. Introduction

The securitized-credit market has played a prominent role in the 2007–2008 financial turmoil originated in the market for subprime residential mortgage-backed securities (RMBS). Given the huge losses that investors have suffered in the complex and opaque securitized-credit market, it is not surprising that these types of investments are frequently termed “toxic” assets. One of probably the most toxic of all toxic assets is certainly a second-layer securitization or ABS-CDO. Since the beginning of the subprime crisis in July 2007, financial institutions around the world have suffered approximately 220 billions of dollars in mark-to-market losses on CDOs backed by tranches of RMBS and other ABS (Benmelech and Dlugosz, 2009). This represents 42% of all crisis-related write-downs as of February 2009. This paper studies empirically how these structured types of securities were valued in the financial markets. This is an important question given the conventional wisdom (e.g., Pagano and Volpin, 2009) that a combination of the following two forces is central to the understanding of the crisis: many investors na-