A Closer Look at Credit Ratings for CDOs

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Abstract

The 2007 credit crisis has raised several questions regarding the meaning of structured finance credit ratings issued by rating agencies and the methodology behind them. This study aims at clarifying some misconceptions related to structured finance ratings and how they are commonly interpreted: we discuss the comparability of structured finance ratings with bond ratings, the interaction between the rating procedure and the structuring procedure and its consequences for the stability of structured finance ratings in time. These insights are illustrated in a Gaussian copula model by simulating rating transitions for CDO tranches. In particular, we show that structured finance ratings follow path-dependent dynamics that cannot be adequately described, as usually done, by a transition matrix. To overcome some of the drawbacks of existing rating methods, we suggest a risk-based rating procedure for CDOs and structured products.