Do credit ratings affect spread and return? A study of structured finance products

We follow a causal interpretation of Structural Equation Modelling (SEM) to investigate potential causal effects of credit ratings on the spread (at issuance) and the return (in transactions) of structured finance products.

The issuance analysis is based on all tranches of asset-backed securities (ABS) issued from December 1999 to December 2015 and traded in the US (in American dollars). The transactional analysis includes 1,309 rating change events concerning 327 securities between February 2001 and December 2015. The data sources in both cases are Bloomberg, Moody's website and Datastream.

After testing all pertinent combinations among the variables considered (involving tranche characteristics and return on alternative investments), we find evidence of causality from rating changes to spread and return at both stages: issuance and transactions, respectively. In fact, the causality effects are stronger at the former than at the latter. In the transactional data, rating changes have causal effect on returns until the day after the event but this influence fades away afterwards.

This study adds to the academic literature by focusing on *causal* connections between ratings and spread or return whilst the existing research in this area has normally been limited to *associative* relationships. We also contribute to the debate on the regulation of credit rating agencies as our findings imply that ratings have an effective influence on decisions made by investors.