Precision of Ratings*

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Abstract

We analyze the equilibrium precision of ratings. Our results suggest that ratings become less precise as the share of uninformed investors and the gains from trade increase. The results provide an explanation for low accuracy of ABS ratings before the financial crisis. We apply the model to evaluate the effectiveness of the recent reform proposals, including Dodd-Frank Act. We show that some policies, in particular, rating standardization and expert liability, reduce market efficiency.

JEL codes: D82, D83, G01, G18, G24, G28, L15.

Keywords: credit rating agencies, ratings accuracy, differentially informed investors, information production and selling.

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