Credit Ratings versus CDS-Implied Ratings: Which Should Investors Look at?

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Credit Ratings versus CDS-Implied Ratings: Which Should Investors Look at? Daniele Visentin Which instrument — between credit ratings and credit default swap (CDS) spreads — best responds to fixed income investors' need to appraise credit risk? Such an assessment becomes necessary because of mounting criticism to rating agencies' promptness in identifying changed credit conditions. An empirical research on a sample of American reference entities is carried out. Cardinal CDS spreads are transformed into ordinal ratings, after adjusting for the systemic component in CDS spread movements. CDS-implied ratings are found to be more timely than agency ratings and thus best suit investors' exigencies. Furthermore, CDS-implied rating changes are found to usually lead agency rating changes. In fact, credit ratings have turned into regulatory licences to access capital markets and do not solely rely on their quality any longer. Simultaneously, the focus has shifted from investors, who used to be the prime users of ratings, to issuers. A reference to the industry's compensation structure helps explain the reason for that. On the other hand, CDS-implied ratings are a tool able to give the point-in-time credit-risk appraisal investors are more interested in.

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