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# Can information imprecision be valuable? The case of credit ratings<sup>☆</sup>

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## ABSTRACT

We develop a model in which credit ratings are endogenously coarse relative to the underlying default probabilities, and ratings precision is countercyclical. Ratings coarseness arises from the profit-maximizing behavior of rating agencies, and coarseness may maximize welfare even when greater ratings precision is costlessly available. Because the private outcome may differ from the socially desirable outcome, a social planner can improve welfare by putting a ceiling (floor) on the rating agency's fee if the desired outcome is coarseness (precision). Strikingly, when information production is costless, ratings coarseness is socially optimal, but it does not arise in the laissez-faire equilibrium, thus inviting regulatory intervention.

## 1. Introduction

Ratings are produced by credit rating agencies (CRAs) which are information intermediaries that acquire and process information about firms, thereby reducing firms' financing frictions. This suggests that CRAs should produce and communicate information that is as precise as possible. Yet, despite the existence of a continuum of default probabilities, there are only about two dozen or so credit ratings. Thus, credit ratings are imprecise indicators of default probabilities when greater precision is technically feasible, suggesting that this imprecision may have value. What is this value and can it arise in a decentralized equilibrium? Moreover, ratings precision seems to be dependent on the business cycle, with greater precision during downturns (e.g., [Griffin and Tang 2012](#)). Why? We address these research questions theoretically in this paper and develop a model consistent with these stylized facts — ratings coarseness and the greater informativeness of ratings during downturns.

In our model, ratings coarseness arises from the profit-maximizing behavior of CRAs, and we examine how coarseness is affected by the

market structure of the CRA industry. Our analysis sheds light on some conflicting empirical findings about the effect of competition on ratings precision — we show that competition may lead to more or less precise ratings, depending on model parameters. Also, we derive conditions under which the decentralized equilibrium outcome differs from the socially desirable outcome, under both monopoly and perfect competition, thus inviting regulation. Strikingly, if information production is costless, the regulator always prefers some degree of coarseness and must intervene to obtain this outcome because the unregulated equilibrium features precise ratings. Yet, if the cost of information production is higher, the market solution can coincide with the planner's solution. This result overturns the conventional intuition that the efficiency of the unregulated outcome declines as the cost of information production increases.

The model we develop is quite simple. There are three types of observationally identical firms that can be either good, intermediate or bad in credit quality.<sup>2</sup> Each firm is privately informed about its type, whereas all other agents have common-knowledge priors captured by a probability distribution over types. Good firms have positive-NPV

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<sup>2</sup> Credit quality in the model corresponds to the firm's probability of default on its debt.

projects, bad firms have negative-NPV projects, and intermediate firms have projects that are positive-NPV if the firm exerts (unobservable and costly) effort and negative otherwise.<sup>3</sup> Effort incentives get weaker as the firm's debt repayment increases. Thus, the model has only two frictions — asymmetric information about firm types and effort-aversion moral hazard.

In the absence of certification by a CRA, securities issued by all firms are priced as a pool. If the fraction of bad borrowers is sufficiently high, the expected NPV becomes negative and the market breaks down as financing is denied to all. CRAs can learn firm types perfectly and assign each firm a rating at a flat fee, which is determined endogenously.

If CRAs provide precise ratings, each firm's type is identified accurately by the market and its debt is accurately priced. The debt interest rate is determined by the participation constraints of investors, which bind in equilibrium (zero expected profits). But, at this equilibrium interest rate, firms of intermediate quality do not exert costly effort because the marginal return on effort exertion is insufficient. Thus, only good firms obtain financing, while intermediate and bad types are excluded.

If, on the other hand, CRAs provide coarse ratings, they pool good and intermediate firms into a single rating category, generating a partial pooling equilibrium in which both good and intermediate firms issue debt, and the debt is priced according to the average quality of the pool, resulting in good firms subsidizing intermediate firms. When the fee charged by the CRA is sufficiently low, there exists a large enough subsidy that makes it incentive compatible for intermediate firms to exert effort. This effort exertion transforms the projects of intermediate firms into positive-NPV projects. Both good and intermediate firms obtain financing, and net social surplus is higher than in the precise-ratings equilibrium. If the fee is higher, coarse ratings pool good and intermediate borrowers without eliciting effort exertion by intermediate firms, which lowers net social surplus.

The preceding analysis does not consider what the CRA would wish to do, so we turn next to the CRA's incentives. We assume that issuing precise ratings entails a cost, while the cost of issuing coarse ratings is normalized to 0. The rating agency chooses a ratings policy (degree of coarseness) and the fee to maximize its profits.

We begin by considering the case in which there is a single CRA. The monopolist CRA's ratings policy is determined by the following tradeoff. With precise ratings, the CRA's fee is higher as it captures the full surplus created by the ratings, but only the good firms purchase ratings and the CRA incurs the cost of precision. With coarse ratings, the CRA's fee from each rated firm is lower, but more firms get rated since good as well as intermediate firms purchase the coarse rating that pools them. The CRA chooses the policy that yields higher profits.

Next, we consider multiple competing CRAs. In this case, competition induces CRAs to charge a fee which equals the marginal cost of issuing a rating. The degree of coarseness is determined by the profit-maximization objective of *good* borrowers. If the subsidy to intermediate borrowers in a pooling equilibrium is smaller than the cost of precision, then coarseness arises in equilibrium. Depending on the parameters, competition may lead to more or less precision than in the case of a monopolist CRA.

The analysis generates numerous empirical predictions. Some are consistent with existing stylized facts, some shed light on conflicting empirical findings, and others are new predictions that await empirical testing.

First, the analysis predicts that changes in competition among CRAs affects ratings precision if the cost of generating this precision is neither too small nor too large. With an intermediate cost, competition leads to coarseness if borrowers' projects are not very profitable, and to greater precision if they are very profitable. This prediction that

competition can lead to more or less ratings coarseness sheds light on conflicting empirical findings — Doherty et al. (2012) and Kisgen and Strahan (2010) find that competition leads to greater ratings precision, whereas Becker and Milbourn (2011) find the opposite.

Second, we relate ratings precision to the business cycle by assuming that the ratio of good to intermediate firms is higher in an economic boom than in an economic downturn.<sup>4</sup> The analysis now predicts that, while ratings coarseness may arise in an economic boom, it disappears in a downturn. This prediction of greater ratings precision in downturns is consistent with the evidence in Ashcraft et al. (2010) and Griffin and Tang (2012).<sup>5</sup>

Third, our model also produces a new prediction that awaits testing — when the cost of information production for CRAs declines, real investment by (rated) firms goes down. This is *counter* to the usual intuition that if information production by CRAs facilitates investments, then a lower information production cost should elevate investment.

Our analysis also generates regulatory policy implications. Depending on the deep parameters, two types of inefficiencies may arise — ratings are coarse in the laissez-faire equilibrium when the socially-desirable outcome is precision, and ratings are precise in the laissez-faire equilibrium when the socially-desirable outcome is coarseness. Thus, the analysis prescribes that the regulator should put a ceiling on the fee if the desired outcome is coarseness, and a floor on the fee if the desired outcome is precision.

This paper is related to the literature on the value of imprecise information. In oligopolistic models of incomplete information, there are conflicting results on the benefits or costs of observing more precise information. In Rotemberg and Saloner (1986) and Vives (1984), observing more precise information has value, whereas the opposite is true in Gal-or (1987). In these models, the firm cannot affect the precision of the information and the quantity of output produced has no effect on the precision. In contrast, Gal-or (1988) develops a model in which experience in production allows firms to internally generate private signals at no cost. When the firm is endowed with less precise information about cost, it has a greater incentive to produce. Information imprecision thus has value because it encourages production. In contrast to this literature, our model focuses on the external provision of information by either monopolistic or competitive CRAs, and shows that information imprecision in communication can mitigate moral hazard and elevate net social welfare even when the entity communicating the information has more precise information in its possession.

Since CRAs are “certification” financial intermediaries, our paper is also related to banking theories in which the bank's decision to lend signals the borrower's creditworthiness to other agents in the economy.<sup>6</sup> For example, the intermediary in Holmstrom and Tirole (1997) performs a role similar to that of the CRAs in our paper, namely the relaxation of the borrowing firms' effort moral hazard constraint. In Holmstrom and Tirole (1997), banks directly monitor the borrowing firms to increase their repayment probability by ensuring that they do not choose bad projects. The resulting enhancement

<sup>4</sup> An alternate way to capture the business cycle would be to assume that the cost of effort for intermediate firms is higher in economic downturns. This interpretation would yield similar predictions.

<sup>5</sup> Bar-Isaac and Shapiro (2013) have a similar result regarding the counter-cyclicality of ratings precision (see also, Bar-Isaac and Shapiro 2011), but the source of imprecision in their model is the higher cost of greater precision. In our model, imprecision can have value even when precision can be costlessly achieved.

<sup>6</sup> Like CRAs, banks have information-cost advantages in producing information about borrowers, because they lend to multiple interconnected borrowers (e.g., Martins et al. 2023). Moreover, banks also produce (credit) ratings of borrowers, although they do this for internal risk assessment purposes in the context of Internal Ratings Based (IRB) models. See Bruno et al. (2023) who document that this reduces banks' opacity, which is important in light of banks' propensity to engage in window dressing around regulatory reporting dates (e.g., Bassi et al. 2024).

<sup>3</sup> The idea is that some firms may have the ability to undertake costly risk management activities to lower their default probabilities.

in the borrower's creditworthiness increases its capacity to borrow from non-bank sources as well. In contrast, in our model, the CRA's effect on the borrowing firm's (effort) moral hazard constraint is indirect, and it works through the pricing of debt. If ratings are coarse, the intermediate borrower's debt is overpriced, which is effectively a subsidy to the borrower. This, in turn, relaxes the borrower's effort moral hazard constraint and induces effort exertion. Another difference between (Holmstrom and Tirole, 1997) and our model is that, in Holmstrom and Tirole (1997), the bank's assessment of the borrower – namely that the borrower's project choice is creditworthy – is not verifiable. Credibility of the bank's assessment is ensured by the capital ratios of the bank and the borrower. In contrast, in our model, we assume that the CRA can commit to a ratings policy and deliver ratings in accordance with that policy.<sup>7</sup>

Our paper is also related to the credit ratings literature. Building on the theories of diversified information-production intermediaries (e.g., Allen 1990, Millon and Thakor 1985, Ramakrishnan and Thakor 1984), a strand of the literature has shown that credit ratings can resolve coordination problems in financial markets (e.g., Boot et al. 2006, Manso 2013, Goldstein and Huang 2020, Terovitis 2022).<sup>8</sup> In these papers, new information arises following the production of ratings, which is not the case in our model. Parlour and Rajan (2020) show that ratings can be valuable in the presence of contract incompleteness. In our setting, welfare is non-monotonic in the precision of information communicated by CRAs.

Other papers have focused on failures in the credit rating process, including incentives for rating agencies to manipulate ratings (e.g., Bolton et al. 2012, Sangiorgi et al. 2009, Skreta and Veldkamp 2009, Opp et al. 2013, Frenkel 2015, Sangiorgi and Spatt 2017). While inflated ratings refer to incorrect ratings that are too high on average – feasible only in settings with naive investors – we consider coarse ratings, which are vague but correct on average, albeit not as finely partitioned as the underlying default probabilities. That is, ratings inflation and coarseness are different phenomena.

Our contribution relative to this literature is that we develop a theory in which ratings coarseness arises endogenously as an equilibrium phenomenon, and this elevates net social surplus. This connects us to papers in which ratings are coarse, like Lizzeri (1999), Doherty et al. (2012), and Ali et al. (2022). In these papers, information communication is endogenously coarse, but coarseness does not impact allocative efficiency. In Kartasheva and Yilmaz (2020), coarseness also arises endogenously due to the monopolist CRA's profit-maximizing behavior, but coarseness destroys welfare. In contrast to these models, coarseness sometimes improves welfare in our theory.

Our result that coarseness can be welfare-improving is reminiscent of Spence (1973), where pooling is always socially efficient, but it does not arise in equilibrium. In contrast, the pooling equilibrium in our model may be socially inefficient for some parameters, but may still arise. Several papers highlight the observation that opacity can be valuable in different contexts (see, for example, Hirshleifer 1971, Crawford and Sobel 1982, Popov and Bernhardt 2013, Bouvard et al. 2015, Dang et al. 2017). In contrast to these models, our result arises from an interaction between adverse selection and moral hazard – specifically, *the presence of the adverse selection friction relaxes the moral hazard constraint*. Additionally, we examine the interaction between coarse information communication and CRA market structure, which yields new predictions consistent with empirical evidence.

<sup>7</sup> For another credit ratings paper with a similar assumption, see Lizzeri (1999).

<sup>8</sup> Thakor and Merton (2023) view credit ratings in the presence of asymmetric information and product complexity as a third-party verification mechanism. In their model, such verification interacts with voluntary information disclosure by firms and influences the complexity of products that firms design.

The paper closest to ours is Goel and Thakor (2015), which also rationalizes coarse ratings. Using a cheap-talk model, the paper shows that ratings coarseness can arise as a second best equilibrium phenomenon even when higher precision can improve investment efficiency. The reason is that coarseness is the only incentive compatible mechanism for truthful communication by the CRA. In contrast, coarseness helps to achieve the first best investment in our model when precision fails to do so. That is, even when the CRA can credibly communicate very precise information, welfare is higher when it chooses imprecision over precision. So, while in Goel and Thakor (2015), the CRA's misrepresentation propensity, engendered by the CRA's objective function and the non-verifiability of its information, leads to ratings coarseness, in our model, the coarseness arises even though the CRA's objective function and the verifiability of its information ensure the absence of a misrepresentation propensity. Thus, one contribution of our paper is that while non-verifiability of information and the associated misrepresentation propensity can deliver coarse ratings, one can get coarse ratings even in the absence of these features. Moreover, this observation leads quite naturally to the fact that the implications of these models are very different; see our discussion of the effect of competition in Section 4.3.

A couple of other comments about ratings coarseness in our model compared to ratings coarseness in cheap-talk models like Goel and Thakor (2015) are in order:

First, in Goel and Thakor (2015), given the beliefs of the receivers of the signal (investors), providing precise ratings is not a credible strategy for the CRA. Thus, the CRA assigns a limited number of ratings for a possibly unbounded number of firm types, with each rating representing a subset of multiple firm types. In contrast, in our model, investor beliefs do not play such a role in determining the CRA's strategy, so providing precise ratings is a feasible strategy for the CRA. However, in assigning ratings, the CRA pools across firm types in our model because it is profit-maximizing for it to do so.

Second, in cheap talk models, there are often multiple equilibria, with one of these equilibria being a completely uninformative ratings equilibrium (i.e., a single rating for all types). In our model, multiple equilibria do not arise because, for each configuration of deep parameters (including the prior beliefs), there is a unique level of ratings precision consistent with equilibrium. This implies that when information is non-verifiable, as in cheap talk models, one is more likely to encounter multiple equilibria, whereas information verifiability (as in our model) is associated with equilibrium uniqueness. How one thinks about relating this to the empirical regularities of credit ratings depends on how one interprets multiple equilibria in the real world. Some interpret these as an inherent inability to predict equilibrium outcomes, and thus a possible oscillation from one equilibrium to another in an intertemporal sense, whereas others view that as interpreting multiple equilibria too literally and taking the notion too far as an indication of intertemporal volatility. However, juxtaposing cheap talk models with ours does imply that when information is verifiable, ratings categories will be uniquely identified in equilibrium and this categorization will be relatively stable over time, so that ratings changes will be quite predictable.<sup>9</sup>

Also related to our work are other models of ratings coarseness. Using insights from the Bayesian persuasion literature, Huang et al. (2023) present a model in which CRAs optimally communicate coarse information (see also, the bank stress test literature, e.g., Goldstein and Leitner 2018, Orlov et al. 2022). Similar to us, models in this literature show that cross-subsidization across types can lead to welfare improvement, but coarseness in these models is the solution of the planner's problem, in contrast to our model in which coarseness arises

<sup>9</sup> Of course, this can also be true with cheap talk models, but the point is that lack of predictability is possible with cheap talk models, but not with ours.



due to market forces. Explicitly modeling the CRA's incentives enables us to make two new contributions: First, we derive empirical predictions relating coarseness to the market structure in the CRA industry. Second, we derive conditions under which the laissez-faire equilibrium differs from the socially desirable outcome and consider regulatory interventions that can improve the equilibrium.

Finally, our paper relates to the literature on competition among CRAs. Some theories explore the interaction between competing CRAs when borrowers may solicit multiple ratings (see e.g., Bar-Isaac and Shapiro 2011, Bouvard and Levy 2018, Farkas 2021, Piccolo 2021). In contrast to these models, the borrower in our setting solicits ratings from a single CRA as there is no value added from purchasing multiple ratings. Other theories study the ratings shopping phenomenon which feature naive investors. We derive conditions under which inefficiencies may arise under monopoly or competition with rational investors, and offer solutions to restore efficiency.

The rest of the paper is organized as follows. Section 2 develops the model. Section 3 presents an analysis of the base model and compares the outcomes across three choices by the CRA: (i) no ratings, (ii) precise ratings, and (iii) coarse ratings. In Section 4 we analyze the endogenous choice of ratings precision by the CRA. Empirical predictions and policy implications are examined in Section 5. Extensions of the base model are analyzed in Section 6. Section 7 concludes. All proofs are in Appendix.

## 2. Model

### 2.1. Set-up

We consider an economy in which all agents are risk-neutral and the discount rate (risk-free rate) is zero. There are three types of agents: firms, CRAs, and investors. A firm has access to a project that needs investment and the scale of the investment is normalized to 1 unit. Each firm has zero initial endowment, so it seeks to raise funds from outside investors to invest in its project. Specifically, each firm raises  $(1 + f)$  from the market; invests 1 unit in the project, and either consumes  $f$  right away or uses  $f$  to pay a fee to a CRA (more details below). Investment occurs at  $t = 0$  and returns are realized at  $t = 1$ , at which point all agents consume.

There are three types of firms and each firm privately knows its type. The common prior belief is that a fraction  $\alpha$  of the firms have good projects,  $g$ , a fraction  $\beta$  have intermediate quality projects,  $m$ , and a fraction  $1 - \alpha - \beta$  have bad projects,  $b$ . A firm succeeds with a type-dependent probability,  $p_i \in \{p_g, p_m, p_b\}$ , and fails with the complementary probability. The project generates a cash flow,  $X > 0$ , if it succeeds, and zero if it fails. Firm types differ only on the probability of success. An intermediate firm can exert hidden effort at a private cost,  $c > 0$ , to increase its success probability by  $\delta$ . In Section 6.1, we present a variant of the model in which there are many borrower-types, and the moral hazard friction applies to each type.

A CRA can perfectly identify a bad firm at zero cost and incurs a cost  $k \geq 0$  to distinguish the good from the intermediate firms, i.e., the marginal cost of producing coarse ratings is normalized to 0, while the marginal cost of producing precise ratings is  $k$ .<sup>10</sup> A firm pays an endogenously determined fixed fee,  $f$ , to the rating agency to certify its type. The fee is paid by firms from the money raised in the market. The modeling of the fee is consistent with the issuer-pays model and reflects the observation that issuers choose to pay for a rating only if the rating they obtain allows them to borrow in the market. The objective of the CRA is to maximize its own expected profit.

We make the following assumptions relating to the deep parameters:

**A1:**  $p_g X - k > 1 > p_m X > p_b X$

<sup>10</sup> Introducing noise in the CRA's default probability discovery does not qualitatively change the results.

Assumption A1 states that good firms have positive-NPV projects after taking into account the marginal cost of producing precise information, while intermediate and bad firms have negative-NPV projects. An intermediate firm can exert effort at a strictly positive cost,  $c > 0$ , to increase the success probability by  $\delta$ , such that its project becomes positive-NPV:

**A2:**  $p_g X - 1 > (p_m + \delta)X - 1 > c > \frac{\delta}{p_m + \delta}((p_m + \delta)X - 1) \equiv c_s$

Combined with A1, the second inequality of A2 implies that exerting effort by intermediate firms is efficient, i.e.,  $\delta X - c > 0$ . The value generated from exerting effort makes intermediate firms' projects positive-NPV. The set-up is meant to reflect the possibility of risk management activities that could help intermediate firms to reduce their default probability. Nonetheless, good firms are still more likely to succeed than intermediate firms (the first inequality in A2). The final inequality of A2,  $c > c_s$ , implies that the cost of exerting effort is sufficiently large, such that intermediate firms do not exert effort given actuarially fair interest rates. This assumption simplifies the analysis by reducing the number of cases that we need to consider.

Bad firms cannot increase the probability of their success by exerting effort. Thus, while it is efficient to finance intermediate firms only if they exert effort, it is always inefficient to finance bad firms. We could also allow good and bad firms to have such a hidden effort choice, but if we assume that a good firm is creditworthy regardless of its effort choice and a bad firm is never creditworthy regardless of its effort choice,<sup>11</sup> our main results are sustained. So, in the interest of simplicity, we do not give good and bad firms this effort choice.

**A3:**  $(\alpha p_g + \beta(p_m + \delta) + (1 - \alpha - \beta)p_b)X < 1 + \beta c$

**A4:**  $(\alpha p_g + (1 - \alpha - \beta)p_b)X < 1 - \beta$

Assumption A3 implies that the expected NPV across all three firm-types is negative, even if intermediate firms exert effort. A4 implies that the expected NPV across good and bad firms is negative. A3 and A4 impose that the fraction of bad firms is so high that they must be excluded from the market.

### 2.2. The game

The stages of the game are as follows:

**Stage 1:** CRAs announce which policy they will adopt and the fee that they will charge the issuers who purchase ratings. A policy is to issue either no ratings, or issue precise ratings, or issue coarse ratings.<sup>12</sup> Without loss of generality, we assume that CRAs charge a flat fee across types. Under precise ratings, the ability to condition the fee on type does not affect the results, while under coarse ratings, it would be necessary to charge a flat fee to sustain the pooling equilibrium.

**Stage 2:** Given what has been announced by CRAs, firms decide whether to get rated. If they choose to get rated, they pay the fee to the CRA.

**Stage 3:** Regardless of whether the firm chose to obtain a rating or not, the firm can propose a debt contract with promised repayment,  $R$ , to competitive investors.

**Stage 4:** Investors form a belief about the firm type given the rating given to the firm (if any) and the offered interest rates. Given these beliefs, investors decide whether to accept or reject the proposed contract. Investment occurs only if the proposed contract is accepted, at which point intermediate firms decide whether to exert unobservable effort.

We look for the pure strategy Perfect Bayesian Nash equilibria of this game that satisfy the Intuitive criterion of Cho and Kreps (1987).

<sup>11</sup> This assumption would be necessary to meaningfully distinguish the intermediate firm from the good and bad firms.

<sup>12</sup> We allow for all possible combinations of coarseness (all types together and three different pairs of two types). In Lemma 1, we show that the only coarse ratings on the equilibrium path is pooling good and intermediate firms.

We solve for the equilibrium backwards. First, we analyze the financing game, conditional on the ratings precision set by CRAs. Then, we derive the CRA's choice of ratings precision by fully anticipating the outcome of the financing game.

Note that in our model, once the CRA announces a ratings policy, it will rate firms in accordance with that policy, i.e., it will not misrepresent the issuer's type. This is in contrast to the cheap talk model of [Goel and Thakor \(2015\)](#) in which the CRA's misrepresentation propensity leads to ratings coarseness to guarantee incentive compatibility in equilibrium. The misrepresentation propensity arises from the CRA's objective function which assigns some weight to the issuer's desire to obtain a better rating to lower its borrowing cost. By contrast, in our model, the CRA's objective function does not generate a misrepresentation propensity.<sup>13</sup>

### 2.3. Benchmark 1: Observable types and effort

We now consider the first best allocation which is the allocation that obtains in the absence of both informational frictions, i.e., firm-types are observable and intermediate firms' effort levels are observable and contractible. Due to competition among investors and full information, the interest rates are such that investors make zero expected profits.

**Proposition 1 (Benchmark 1).** *In the first best equilibrium, good and intermediate firms obtain financing and intermediate firms exert effort. Bad firms do not obtain financing. The interest rates are as follows:*

$$R_g = \frac{1+f}{p_g} \quad (1)$$

$$R_m = \frac{1+f}{p_m + \delta} \quad (2)$$

The marginal benefit of an increase in effort in terms of an increase in the expected return exceeds the marginal cost of that effort. Therefore, in the first best, intermediate firms choose a contract which implements the efficient effort level. The interest rates in Eqs. (1) and (2) are determined by competition among investors which sets these rates to yield investors to zero expected returns.

### 2.4. Benchmark 2: Observable types and unobservable effort

In this section, we consider the case in which firm-types are observable but effort is not observable, and hence, not contractible. Given observable types, good firms receive financing at interest rate,  $R_g$ , and invest. Bad firms do not obtain financing since they have negative-NPV projects. Consider the effort incentive constraint of an intermediate firm:

$$(p_m + \delta)(X - R) - c \geq p_m(X - R) \quad (3)$$

The left-hand side (LHS) represents intermediate firms' expected profits when exerting effort, while the right-hand side (RHS) represents the expected profits when not exerting effort. From Eq. (3), an intermediate firm exerts effort only if the interest rate is sufficiently small:

$$R \leq X - \frac{c}{\delta} \equiv \underline{R} \quad (4)$$

The difference between  $\frac{c}{\delta}$  and  $c$  is the rent that intermediate firms should receive to exert effort, and this is the source of the effort underprovision inefficiency. If the equilibrium interest rate is higher

<sup>13</sup> Moreover, the distribution of firm types is known ex ante. If the CRA rates numerous firms, the realized distribution converges to the ex ante distribution by the law of large numbers. Thus, market participants can infer ex post whether there was misrepresentation by the CRA, and this can further strengthen the CRA's interest to not misrepresent. This would be especially true in a repeated-game setting with reputational concerns. See, for example, [Thakor and Merton \(2024\)](#).

than  $\underline{R}$ , intermediate firms' incentive compatibility (IC) constraint for effort provision is violated. Suppose that the investors believe that intermediate firms will exert effort. Intermediate firms will raise funds at interest rate,  $R_m$ , which sets the competitive investors' expected returns to zero. However,  $\underline{R} < R_m$  holds since  $c > c_s$  (Assumption A2). Thus, with observable types, investors' belief that intermediate firms exert effort is not validated. This implies that the investment of intermediate firms will be negative-NPV and so for any  $R \leq X$ , investors' participation constraint is violated. As a result, intermediate firms do not receive financing.

**Proposition 2 (Benchmark 2).** *Suppose that firm-types are observable but effort is not. Good firms obtain credit at interest rate,  $R_g$ , while intermediate and bad firms do not obtain financing.*

### 3. Outcome under each CRA policy separately

In this section, we examine the case in which both informational frictions are present. To ease exposition, prior to endogenizing CRAs' choice of ratings precision, we analyze the outcome for each of the following three cases: CRAs provide (1) no ratings or (2) precise ratings or (3) coarse ratings. In Section 4, CRAs optimally choose whether to provide precise or coarse ratings and the fee that they charge in order to maximize their profits.

#### 3.1. Outcome under no ratings

First we consider the case in which CRAs do not provide ratings. Even if lenders offer an interest rate which is meant for good firms under full information, so that intermediate firms exert effort, the average NPV across all three types is negative (see A3); all three types will be in the applicant pool since the lower types have an incentive to mimic the good type at any pooling rate. Thus, no firm obtains financing.<sup>14</sup> At higher interest rates, the intermediate borrower may not exert effort and the average credit quality of the borrower pool (as measured by the average NPV across all types) will be worse, so no credit will be forthcoming. Thus, it is never possible for firms to obtain financing without credit ratings.

**Proposition 3 (No Ratings).** *In the absence of credit ratings the unique equilibrium is the one in which no firm obtains financing (market breakdown).*

#### 3.2. Outcome under precise ratings

In this section, we consider the case in which CRAs assign precise ratings. Since we consider perfect learning by the CRAs at a cost  $k$ , the analysis in this case is similar to the case in which firm types are observable but effort is not observable. Because ratings are precise, investors know the firm type and they do not need to make any inferences about firm types from the offered contracts, i.e., investors' beliefs do not play a role in this case. The equilibrium is identical to the one derived in [Proposition 2](#) in terms of allocation. The minimum fee that CRAs may charge is the marginal cost of precision,  $f = k$ , and the maximum fee is denoted  $f_p$  and it equals the NPV of a good borrower's project. A higher fee would violate the participation constraints of investors. The case of precise ratings improves upon the situation with no ratings since it eliminates the market breakdown equilibrium. The precise-ratings equilibrium is inefficient compared to the first best because, unlike the first best, intermediate firms do not obtain financing.

<sup>14</sup> This is a sequential equilibrium that survives the Intuitive Criterion. The reason is that there exist 'out-of-equilibrium' investor beliefs that would induce a defection from this equilibrium by every type of firm, so Step 1 of the Intuitive Criterion does not eliminate any type.

**Proposition 4 (Precise Ratings).** Suppose that ratings are precise. Only good firms obtain credit at interest rate,  $R_g$ , and they pay a fee,  $f \in [k, f_p]$ , with,  $f_p = p_g X - 1$ .

### 3.3. Outcome under coarse ratings

We now consider the case of the CRA assigning coarse ratings.

**Lemma 1.** The only coarse categorization which is not equivalent to the no-ratings or precise-ratings allocation is the one which pools good and intermediate firms.

Given Lemma 1, for the rest of the analysis, whenever we refer to coarse ratings we consider the case in which good and intermediate firms are pooled together in a single ratings category. Under coarse ratings, the debt issued by good and intermediate firms is priced according to the average quality of the pool. If intermediate firms exert effort, then the average NPV of the coarse-ratings pool is positive. If intermediate firms do not exert effort, the average NPV of the pool may be positive or negative; it is positive if the ratio of good firms to intermediate firms is sufficiently high:

$$\left( \frac{\alpha}{\alpha + \beta} p_g + \frac{\beta}{\alpha + \beta} p_m \right) X - 1 \geq 0$$

$$\Rightarrow \frac{\alpha}{\beta} \geq \frac{1 - p_m X}{p_g X - 1} \equiv \gamma \quad (5)$$

The following lemmas derive the pooling interest rate and the parameters under which it is feasible to elicit effort provision by intermediate borrowers in a coarse-ratings equilibrium.

**Lemma 2.** For a given fee,  $f$ , the interest rate in a coarse-ratings equilibrium is  $R_e^P$  with  $e = 1$  if intermediate borrowers exert effort and  $e = 0$  if they do not.

$$R_e^P = \frac{(\alpha + \beta)(1 + f)}{\alpha p_g + \beta(p_m + \delta e)} \quad (6)$$

Under coarse ratings, by being pooled with good borrowers, intermediate borrowers receive an effort-inducing subsidy in terms of a lower interest rate compared to the precise-ratings case.

**Lemma 3.** Suppose  $f = 0$ . Under coarse ratings, intermediate borrowers exert effort if  $c \leq c_p$ , where  $c_p$  is given by:

$$c_p \equiv \delta X - \frac{\delta(\alpha + \beta)}{\alpha p_g + \beta(p_m + \delta)} \quad (7)$$

Moreover,  $c_p > c_s$  always holds.

This analysis shows that intermediate firms exert effort when ratings are coarse, but not when the ratings are precise, implying that the coarse-ratings case involves a higher net social surplus. We refer to this as the “bright side” of coarseness.<sup>15</sup> Note that  $c_p$  is derived assuming  $f = 0$ . Hence, if  $c > c_p$ , there is no fee for which pooling will elicit effort exertion by intermediate borrowers.

We define an incentive compatible upper bound on the fee,  $\bar{f}_c$ , such that if  $f \leq \bar{f}_c$ , the subsidy they obtain from good firms in the pool is large enough to induce intermediate borrowers to exert effort. If  $f > \bar{f}_c$ , the subsidy is insufficient to elicit effort exertion, i.e., the pooling interest rate assuming that intermediate firms exert effort,  $R_{e=1}^P$ , is higher than the incentive compatible interest rate,  $\underline{R}$ .  $\bar{f}_c$  is given by:

$$\bar{f}_c \equiv \frac{1}{\delta(\alpha + \beta)} [(\delta X - c)(\alpha p_g + \beta(p_m + \delta))] - 1 \quad (8)$$

<sup>15</sup> The “dark side” of coarseness is that it may allow intermediate firms to invest even when they do not exert effort (which is value-destroying).

Note that  $\bar{f}_c$  is falling in  $c$  and  $\bar{f}_c \geq 0$  holds if  $c \leq c_p$ . For  $c > c_p$ ,  $f = \bar{f}_c$  is not feasible since  $\bar{f}_c$  becomes negative, and the CRA does not participate.

If intermediate borrowers do not exert effort, the maximum fee that CRAs may charge is denoted as  $\hat{f}_c$ , which reflects the average quality of the pool when intermediate borrowers do not exert effort:

$$\hat{f}_c \equiv \frac{1}{\alpha + \beta} [(\alpha p_g + \beta p_m)X] - 1 \quad (9)$$

Which equilibrium obtains depends on the deep parameters and the fee charged by the CRA, as the following result shows:

**Proposition 5 (Coarse Ratings).** Suppose that ratings are coarse. If  $c \leq c_p$  and the fee is sufficiently low,  $f \in [0, \bar{f}_c]$ , both good and intermediate firms obtain financing and intermediate firms exert effort. For higher fees,  $f > \bar{f}_c$ :

1. For  $\frac{\alpha}{\beta} \geq \gamma$ , both good and intermediate firms obtain financing. However, intermediate firms do not exert effort if  $f \leq \hat{f}_c$ , and the market breaks down if  $f > \hat{f}_c$ .
2. For  $\frac{\alpha}{\beta} < \gamma$ , the market breaks down.

Under coarse ratings, intermediate firms exert effort when the fee charged by the CRA is sufficiently low,  $f \leq \bar{f}_c$ . However, if the fee charged under coarse ratings is higher, intermediate firms may obtain financing if the lenders can break even on average, which happens if the ratio of good to intermediate firms is sufficiently high (i.e.,  $\frac{\alpha}{\beta} \geq \gamma$ ), but they do not exert effort.<sup>16</sup> If  $c > c_p$ , for any non-zero fee, the most efficient outcome is obtained with precise ratings, i.e., by completely eliminating the information asymmetry problem, since it is more efficient to not have intermediate firms invest than for them to invest but not exert effort.

## 4. Equilibrium

In this section, we allow the CRAs to optimally choose whether they offer precise or coarse ratings and set the fee, and we analyze the market equilibrium under different market structures in the CRA industry.

### 4.1. Equilibrium with a monopolist CRA

We begin by characterizing the equilibrium when there is a monopolist CRA. The CRA maximizes its profits by jointly choosing the ratings policy and the fee. In the next two lemmas, we derive the equilibrium fee under different circumstances and order them, respectively.

**Lemma 4.** The fee charged by the CRA depends on the deep parameters and the ratings policy chosen as follows:

1. If ratings are precise, then for all parameters the fee is  $f_p$ .
2. If ratings are coarse and  $\frac{\alpha}{\beta} \geq \gamma$ , the fee is  $\max(\bar{f}_c, \hat{f}_c)$ .
3. If ratings are coarse and  $\frac{\alpha}{\beta} < \gamma$ , the market breaks down.

The next result compares the fees with precise and coarse ratings.

**Lemma 5.**  $f_p > \max(\bar{f}_c, \hat{f}_c)$  and  $\bar{f}_c \geq \hat{f}_c$ , if:

$$c \leq \frac{\beta X \delta^2}{\alpha p_g + \beta(p_m + \delta)} \equiv \bar{c} \quad (10)$$

There exist feasible parameters for which  $\bar{c} > c_s$ .

<sup>16</sup> For now, we take coarseness as given, and examine the effect of different levels of the CRA’s fee on the borrowers’ effort choice. However, in equilibrium, the degree of coarseness and the fee are endogenously co-determined. Since the fee is endogenous, we cannot perform comparative static exercises with respect to this variable.



The monopolist CRA charges a higher fee in the precise-ratings equilibrium because good borrowers have an NPV that is higher than that of the average borrower in the coarse pool, whether or not intermediate borrowers exert effort. The incentive compatible fee,  $\hat{f}_c$ , may be higher than the incentive incompatible fee,  $\hat{f}_e$ , if the surplus created from effort exertion is sufficiently large, which is the case if the cost of effort is sufficiently small,  $c \leq \bar{c}$ .

In maximizing its expected profit, the constraint that the CRA faces is that investors, who use the ratings, have rational expectations. Hence, if ratings are uninformative, investors will not rely on them, and firms will consequently not purchase ratings. The CRA faces the following tradeoff in choosing between precise and coarse ratings: On the one hand, the fee is higher with precise ratings, i.e.,  $f_p > \max(\hat{f}_c, \hat{f}_e)$ . On the other hand, only good borrowers obtain ratings when ratings are precise, whereas both good and intermediate borrowers get rated when ratings are coarse. Moreover, in choosing its coarse ratings policy, the CRA also needs to choose between the incentive compatible fee and the incentive incompatible fee. Below, we characterize the equilibrium of the game:

**Proposition 6 (Monopolist CRA).** *Ratings coarseness arises if either one of the following conditions is met:*

$$k \geq k_1 \equiv \frac{1}{\alpha\delta} [(\alpha p_g + \beta(p_m + \delta))c - \beta\delta((p_m + \delta)X - 1)] \quad (11)$$

$$k \geq k_2 \equiv \frac{\beta(1 - p_m X)}{\alpha} \quad (12)$$

There exist feasible parameters for which  $k > k_1$  and  $k > k_2$ . If  $k < \min(k_1, k_2)$ , the equilibrium features precise ratings and the fee is  $f_p$ . In a coarse-ratings equilibrium, the fee is  $f = \hat{f}_c$  and intermediate borrowers exert effort if  $c \leq \min(c_p, \bar{c})$ , and the fee is  $f = \hat{f}_e$  and intermediate borrowers do not exert effort, otherwise.

**Proposition 6** says that good and intermediate firms are pooled into a single ratings category by the CRA because this maximizes its profits. Interestingly, the cross-subsidization with coarse ratings improves welfare because it elicits effort from intermediate borrowers that would not have been forthcoming if their securities were accurately priced, even though this welfare enhancement is not what motivates the CRA to opt for ratings coarseness. As a corollary to **Proposition 6**, we state the following:

**Corollary 1.**  $\min(k_1, k_2) > 0$ . For  $k$  arbitrarily close to 0, the equilibrium with a monopolist CRA features precise ratings.

#### 4.2. Perfect competition

In this section, we model competition by assuming that there is free entry of CRAs. Given the degree of ratings precision, if a CRA charges a fee above the marginal cost to produce it, a competing CRA will always offer an  $\epsilon$  less to attract the issuing firms. Following the classic Bertrand argument, this iterates until the fee equals the marginal cost.

**Lemma 6.** *With free entry of CRAs, the fee always equals the marginal cost of producing a rating; i.e.,  $f = k$  for precise ratings and  $f = 0$  for coarse ratings.*

Given **Lemmas 3** and **6**, intermediate borrowers exert effort (i.e.,  $e = 1$ ) under coarse ratings if the cost of exerting effort is sufficiently small,  $c \leq c_p$ . For  $\frac{\alpha}{\beta} \geq \gamma$ , the coarse-ratings equilibrium arises also for  $c > c_p$ , but the subsidy is not sufficient to induce intermediate firms to exert effort (i.e.,  $e = 0$ ). The magnitude of the subsidy that a good firm provides to intermediate firms in the pool is:

$$p_g(R_e^P - R_g) = \frac{\beta(p_g - (p_m + \delta e))}{\alpha p_g + \beta(p_m + \delta e)} \equiv \sigma_e \quad (13)$$

where  $R_e^P$  is the equilibrium pooling repayment rate for effort,  $e \in \{0, 1\}$  (derived by setting  $f = 0$  in Eq. (6)). We denote the subsidy as  $\sigma_e$ , where  $e = 1$  if  $c \leq c_p$  and  $e = 0$  if  $c > c_p$ .  $\sigma_e$  is always positive. We characterize the equilibrium below:

**Proposition 7 (Competition).** *With free entry of CRAs, the equilibrium is coarse if  $k \geq \sigma_e$ , and precise if  $k < \sigma_e$ .  $e = 1$  if  $c \leq c_p$  and  $e = 0$  if  $c > c_p$ .*

This proposition says that whether the equilibrium features coarse or precise ratings depends on which categorization is preferred by good firms. If the cost to produce precise ratings is small, i.e.,  $k < \sigma_e$ , the coarse-ratings equilibrium does not survive because a new entrant CRA can offer precise ratings to skim the cream and attract only good firms.<sup>17</sup> Since  $\sigma_e$  is positive, for  $k$  sufficiently small, the equilibrium features precise ratings. If  $k \geq \sigma_e$ , the precise-ratings equilibrium does not survive since the entrant CRA can attract good firms by offering coarse ratings. This deviation is costly for good firms since it entails subsidizing intermediate firms. Nonetheless, good firms benefit from the lower fee,  $f = 0$ , and this benefit exceeds the cost.

As a corollary of **Proposition 7**, we state the following counter-intuitive result relating net social welfare to the cost of producing information by the CRA.

**Corollary 2.** *For  $c \leq c_p$ , net social surplus is (weakly) increasing in the cost of information production,  $k$ .*

For  $c \leq c_p$ , net social surplus is maximized under coarse ratings, which arises for  $k \geq \sigma_e$ . A lower cost,  $k < \sigma_e$ , leads to precise ratings and a lower net social surplus.

#### 4.3. Monopoly vs. competition

In this section, we show that competition among CRAs may lead to more or less coarseness. In the case of a monopolist CRA, the degree of coarseness is determined by the CRA's profit-maximizing objective. The monopolist CRA offers coarse ratings if  $k_1$  and  $k_2$  are small (i.e.,  $k > \min(k_1, k_2)$ ). By contrast, competitive CRAs behave in a way that maximizes the expected return of good borrowers, and this then determines whether coarseness or precision arises. If the subsidy to intermediate borrowers,  $\sigma_e$ , is smaller than the cost of precision, then competition among CRAs results in coarse ratings. Whether competition leads to more or less coarseness depends on the deep parameters of the model. Specifically, if  $c \leq c_p$ , then there exists a threshold,  $\bar{X}_1 \in \mathbb{R}$ , such that the relationship between the degree of competition among CRAs and the level of ratings precision changes depending on whether  $X$  is above or below  $\bar{X}_1$ . When  $c > c_p$ , the analogous threshold is  $\bar{X}_2 \in \mathbb{R}$ . This is described in the next proposition.

**Proposition 8 (Monopoly vs. Competition).** *Suppose that  $c \leq c_p$ . Then, there exist values of  $k$  for which monopoly features coarse ratings and competition features precise ratings if  $X > \bar{X}_1$ . If  $X < \bar{X}_1$ , then there exist values of  $k$  for which monopoly features precise ratings and competition features coarse ratings. The analogous threshold for the case of  $c > c_p$  is  $\bar{X}_2$ .*

The subsidy from good borrowers to bad borrowers in a coarse pool,  $\sigma_e$ , is unaffected by  $X$ , so  $X$  does not affect the condition under which coarseness arises when CRAs compete (i.e.,  $k > \sigma_e$ ). However,  $k_1$  and  $k_2$  are decreasing in  $X$  (since  $\bar{f}_c$  and  $\hat{f}_c$  are increasing in  $X$ ), implying that the condition for coarseness under monopoly is easier to satisfy for higher values of  $X$ . Thus, for  $X$  sufficiently small,  $\sigma_e < \min(k_1, k_2)$ , and there are values of  $k$  for which there is precision under monopoly and coarseness under perfect competition. Similarly, for  $X$  sufficiently large,  $\min(k_1, k_2) < \sigma_e$ , and there are values of  $k$  for which there is precision under competition and coarseness under monopoly. The result that competition among CRAs may lead to more or less precision (depending on parameters) differs from existing papers. For example, in **Lizzeri (1999)**, competition leads to information revelation, while in **Goel and Thakor (2015)**, competition leads to more coarseness.

<sup>17</sup> Of course, competition ensures that the CRA just recovers its marginal cost of producing precise ratings, i.e.,  $f = k$ .

## 5. Policy and empirical implications

In this section, we discuss the new policy implications and empirical predictions yielded by our baseline model.

### 5.1. Policy implications

Consider a planner whose objective is to maximize net social surplus. Can the planner intervene to improve upon the unregulated, laissez-faire outcome? If so, how should the planner intervene? We show that the planner can obtain the efficient outcome by using two tools — influencing the degree of competition among CRAs and regulating the fee charged. In the unregulated equilibrium, two types of inefficiencies may arise.

First, only good borrowers obtain financing when ratings are precise, even though coarse ratings and low fees would elicit effort provision by intermediate borrowers when the cost of exerting effort is sufficiently small. Under monopoly, this inefficiency of credit availability for only good borrowers arises in the laissez-faire if  $k < k_1$  and  $c < \bar{c}$ . Under competition, this inefficient outcome obtains if  $k < \sigma_{e=1}$  and  $c \leq c_p$ . In monopoly, it is the CRA's profit maximization motive that generates the inefficiency, whereas in competition the inefficiency arises due to the threat of undercutting by competitors. The planner can obtain the efficient outcome – in which both good and intermediate borrowers obtain credit and intermediate borrowers exert effort – by setting a ceiling on the fee, where the ceiling depends on the market structure in the CRA industry.

Second, suppose that the ratio of good to intermediate borrowers is high, i.e.,  $\frac{\alpha}{\beta} > \gamma$ . If ratings are coarse, then both good and intermediate borrowers obtain financing, but intermediate borrowers may not exert effort. Under monopoly this effort inefficiency arises if  $k > k_2$  and  $c > \bar{c}$ ; note that in this case, the monopolist CRA charges a fee,  $\hat{f}_c$  and obtains the full surplus generated. Under competition this inefficiency arises if  $k > \sigma_{e=0}$  and  $c > c_p$ . The efficient outcome – involving only the good borrowers obtaining financing – may thus be obtained by putting a floor on the fee. The planner implements the floor if the value destruction due to the participation of intermediate firms is greater than the total cost of precision:

$$\beta(1 - p_m X) > \alpha k \quad (14)$$

The above condition becomes  $k < k_2$ . Noting that coarseness (without effort provision by intermediate borrowers) may arise under monopoly only if  $k > k_2$ , the planner cannot eliminate this inefficiency by setting a floor on the fee in the monopolist CRA case. The intuition is that since the monopolist CRA keeps the full surplus (when  $f = \hat{f}_c$ ), it acts as the planner would, which rules out any scope for intervention by the planner. When CRAs compete, the floor enables the achievement of the efficient outcome when  $k \in (\sigma_{e=0}, k_2)$ .

We characterize the optimal intervention by the planner in different circumstances in the following proposition.

#### Proposition 9 (Optimal Intervention).

1. Suppose that  $c \leq c_p$ . The constrained efficient outcome is to have coarse ratings and low fees, but this outcome may not obtain in the laissez-faire equilibrium. Thus, if ratings are precise, the planner can achieve the constrained efficient outcome by putting a ceiling on the fee, with the ceiling depending on the competitive structure of the CRA industry. The ceiling is  $f \leq \bar{f}_c$  under a monopolist CRA, and  $f < k$  when CRAs compete.
2. Suppose that  $c > c_p$  and  $k < k_2$ . The constrained efficient outcome features precise ratings. In the laissez-faire equilibrium, ratings are precise under a monopolist CRA, but may be coarse when CRAs compete. The planner can achieve the constrained efficient outcome with competitive CRAs by putting a floor on the fee,  $f \geq k$ , if  $k \in (\sigma_{e=0}, k_2)$ .

For  $c \leq c_p$ , the coarse ratings equilibrium is welfare-equivalent to the first best. However, high fees charged by the monopolistic CRA can destroy this equilibrium. Interestingly, although competition among CRAs reduces fees, it does not necessarily lead to welfare-improving coarseness. Regardless of the CRA market structure, the regulator can improve welfare by putting a ceiling on the fee. Note that when we consider the special case of  $k = 0$ , the ceiling that ensures coarseness under perfect competition,  $f < k$ , is not effective on its own since the fee cannot be negative. In this case, the regulator must also restrict competition to obtain the efficient outcome.

For  $c > c_p$  and  $\frac{\alpha}{\beta} \geq \gamma$ , low fees can allow the existence of the coarse-ratings equilibrium. However, for these parameters, intermediate firms obtain financing without exerting effort. To eliminate this undesirable equilibrium, the planner can impose a floor on the fee. For a sufficiently high floor, the coarse-ratings equilibrium collapses, and ratings become precise.

As a corollary of Proposition 9, we present the following result:

**Corollary 3.** For  $k = 0$  and  $c \leq c_p$ , regardless of the market structure, the planner prefers coarse ratings, while the equilibrium features precise ratings.

This result says that if the cost of effort provision by intermediate borrowers is sufficiently small, the social planner *always* prefers coarse ratings if the cost of information acquisition is also small enough. Since precise ratings arise in the laissez-faire equilibrium when  $k = 0$ , regulatory intervention is necessary to obtain the efficient outcome. Yet, for a higher cost of information production, the market solution may coincide with the second best. Thus, this result overturns the conventional intuition that the efficiency of the unregulated outcome is monotonically decreasing in the cost of information production.

These policy implications rest on the presumption that the fees charged by the rating agencies are of sufficient magnitude to matter for the effort choices of firms. Beatty et al. (2019) document that fees charged by rating agencies are 6 to 8 basis points (bps) of the par issue amount.<sup>18</sup> Business loans at banks in 2019 cost between 6% and 12%, so the ratings fees may effectively add to the firm's overall cost an amount that is roughly 1% of the borrowing cost. It is difficult to determine the empirical significance of this for borrower effort choices in the absence of a reliable empirical estimate of the marginal cost of effort, but this cost addition due to the fee seems non-trivial at the margin. Moreover, the ratings fee and ratings coarseness are endogenously co-determined in equilibrium, so we cannot do comparative statics on the equilibrium effort with respect to the fee, holding coarseness fixed, nor can we say anything about (larger) out-of-equilibrium fees that would have produced large effort effects.<sup>19</sup>

Finally, while our analysis focuses on the role of regulation in the setting of CRA fees, one could also visualize the regulator playing a prudential role, ensuring that CRAs do not engage in misrepresentation if incentives to do so exist. Prudential regulation in banking provides a good example.<sup>20</sup>

<sup>18</sup> S&P is documented to charge an average ratings fee of about \$12,450 on an average issue size of \$16 million (i.e., approximately 8 bps), and Moody's and Fitch charge an average fee of \$15,688 on an average issue size of \$23 million.

<sup>19</sup> In our analysis, because the CRA does not have an incentive to misrepresent the ratings, the magnitude of the fee does not play a role in ensuring incentive compatibility in ratings determination. Thakor and Merton (2024) develop a theory in which the intermediary's profit margin affects its incentive compatibility constraint.

<sup>20</sup> For example, Ma and Vadasz (2024) provide evidence that prudential regulation eliminates banks' incentives to engage in costly signaling of their own creditworthiness and still ensure incentive compatibility. For prudential regulation to have an advantage over market participants in providing such discipline, they should have access to valuable forward-looking information. See, for example, Guettler et al. (2024).

## 5.2. Empirical implications

In this subsection, we discuss the empirical implications of the analysis.

1. *Higher competition among CRAs leads to more precise ratings when projects are very profitable, and it leads to coarseness otherwise.* From Proposition 8, if  $X$  is sufficiently large (see conditions (39) and (40)), then there are values of  $k$  such that monopoly features coarse ratings and competition features precise ratings,  $\sigma_e > k > \min(k_1, k_2)$ . For smaller  $X$ , there are values of  $k$  such that competition features coarse ratings and monopoly features precise ratings,  $\min(k_1, k_2) > k > \sigma_e$ . Intuitively, the differences between the monopoly and competition cases arise because  $\sigma_e$  (the subsidy from good to intermediate borrowers under perfect competition) is unaffected by  $X$ , while the fee charged in the monopoly case is increasing in  $X$ . The prediction that higher competition among CRAs may lead to more or less coarseness sheds light on conflicting empirical findings. On the one hand, Doherty et al. (2012) and Kisgen and Strahan (2010) find that higher competition among CRAs leads to more informative ratings. On the other hand, Becker and Milbourn (2011) show that increased competition leads to more issuer-friendly and less informative ratings. Our analysis indicates that borrower profitability acts as a mediating variable in the relationship between CRA competition and ratings informativeness, so this relationship should account for this.
2. *Ratings precision is countercyclical.*

Suppose that there is one CRA. Both good and intermediate firms obtain credit. Suppose that the cost of exerting effort is high,  $c > c_p$ , such that intermediate firms do not exert effort. Then, as long as the ratio of good to intermediate firms is high,  $\frac{\alpha}{\beta} \geq \gamma$ , the coarse-ratings equilibrium obtains. However, as the ratio falls below  $\gamma$ , the coarse-ratings equilibrium is no longer viable since it will be characterized by no financing for any firms. In this case, the CRA will offer precise ratings to separate good firms from intermediate firms. Therefore, ratings become more precise as  $\frac{\alpha}{\beta}$  falls. Assuming the ratio of good firms to intermediate firms is high in an economic boom and low in an economic downturn, it follows that the precision of ratings will be higher in downturns than in booms. The prediction is consistent with the findings in Ashcraft et al. (2010) and Griffin and Tang (2012).

In particular, Griffin and Tang (2012) document that, during the boom period leading up to the global financial crisis of 2007–2009, a leading CRA frequently made subjective (not model-based) adjustments to firms' ratings. This increased the number of securities in the highest ratings category, diluting the value of obtaining the highest rating because the highest credit-quality tranches subsidized the lower credit-quality tranches within the same rating category. Further, they found that firms whose ratings were most positively adjusted suffered the biggest downgrades in a subsequent downturn. Viewed through the lens of our model, this observation is consistent with intermediate firms being pooled into the highest category with good firms in booms, but subsequently downgraded in downturns.<sup>21</sup>

3. *A lower cost of information production by CRAs leads to lower investment.*

For a lower cost of information production ( $k < \sigma_e$ ), ratings are precise, which drives out intermediate firms and leads to lower aggregate investment. An ideal test of this prediction would involve a shock that lowers the information production costs of CRAs, but not that of the market. This prediction is yet to be empirically tested.

## 6. Extensions

In this section, we present two extensions.

### 6.1. A more general model

In the baseline model, there are three types of firms and the effort moral hazard friction applies only to the intermediate firms. In this extension, we model more than three types of firms and each type suffers from effort-related moral hazard. We show that firms in multiple ratings categories obtain financing and welfare-improving coarseness arises across the ratings spectrum.

There are  $2N$  types of firms and each firm privately knows its type. A firm of type  $j$  has success probability  $p_j$ , with  $j \in \{1, 2, \dots, 2N\}$ , with  $p_1 < p_2 < \dots < p_{2N}$ , with  $p_1 X - 1 > 0$ . The fraction of each firm-type in the economy is  $\frac{1}{2N}$ . Additionally, there are infinitely many bad firms with success probability,  $p_b = \epsilon$  where  $\epsilon$  is arbitrarily close to 0. Any pool of borrowers containing these bad firms will have an expected NPV that is negative, implying that firms of type  $p_j$  must be rated to obtain financing in the market. Each firm of type  $j$  may improve its success probability by  $\delta$  by exerting unobservable effort at a cost,  $c(\delta) = \frac{\tau}{2}\delta^2$ . The cost function is convex in  $\delta$ , and  $\tau$  is a strictly positive constant, reflecting the marginal value of effort.

CRAs are competitive and observe that any adjacent pair of firms,  $2j - 1$  and  $2j$ , will have a lower success probability than the next pair,  $2j + 1$  and  $2j + 2$ , at zero cost. CRAs incur a cost of precision,  $k > 0$ , to distinguish the adjacent types,  $2j - 1$  and  $2j$ . That is, for example, a CRA observes at zero cost that firms of type  $j = 1$  and  $j = 2$  have a lower success probability than firms of type  $j = 3$  and  $j = 4$ , but it must incur the cost of precision to distinguish firms of type  $j = 1$  from firms of type  $j = 2$  (and firms of type  $j = 3$  from type  $j = 4$ ). That is, having access to a coarse partitioning of firm types is costless for the CRA, but it must incur a marginal cost to obtain a finer partitioning. Specifically, to the CRA consecutive firm types when the lower type in the pair is odd-numbered (e.g.,  $j = 1$  and  $j = 2$ ,  $j = 3$  and  $j = 4$ , and so on) are observationally identical based on hard information such as financial reports, with deeper investigations that rely on the acquisition of additional information revealing differences between these firm types (i.e., between  $j = 1$  and  $j = 2$ , etc.).<sup>22</sup>

The CRA generates a rating that is either precise or coarse and the CRA's fee,  $f$ , equals the marginal cost of producing the rating, i.e.,  $f = k$  for precise ratings and  $f = 0$  for coarse ratings. If a firm of type  $j$  is precisely identified, it promises a repayment,  $R_j$ , and chooses  $\delta$  subject to investors' participation constraint (which binds):

$$\delta_j^* = \arg \max (p_j + \delta_j)(X - R_j) - \frac{\tau}{2}\delta_j^2 \quad (15)$$

$$\text{subject to } (p_j + \delta_j^*)R_j - 1 = 0 \quad (16)$$

<sup>21</sup> Of course, in the real world, we do not observe CRAs altering the number of ratings categories over the business cycle. The following illustrative example clarifies how our model may be applied in practical scenarios. Consider a situation where there are two ratings categories, namely A and B. Category A consists of firm-types  $p_1$  and  $p_2$ , whereas category B comprises firm-types  $p_3$  and  $p_4$  (with  $p_1 > p_2 > p_3 > p_4$ ). During a recession, firm-type  $p_3$  is elevated to category A, while in an economic upturn, it is downgraded.

<sup>22</sup> We adopt this modeling strategy to generate precise predictions. If we allowed for more general formulations, then, in equilibrium there could be different combinations of firm types clustered together. In that case, we would be unable to pin down the equilibrium — the multiplicity here is driven purely by the profit maximizing behavior of CRAs and not the beliefs of the receivers of information, as in cheap talk games.



The first best effort level is derived by ignoring moral hazard, and is given as follows:

$$\delta^{fb} = \frac{X}{\tau} \quad (17)$$

The solution of the problem taking into account the moral hazard friction is as follows<sup>23</sup>:

$$\delta_j^* = \frac{X - p_j\tau + \sqrt{(X - p_j\tau)^2 + 4\tau(p_jX - 1)}}{2\tau} \quad (18)$$

**Lemma 7.**  $\delta_j^*$  is increasing in  $p_j$ .

Higher types have a higher non-effort component of success probability (i.e.,  $p_j$  is increasing in  $j$ ). This implies that the debt issued by higher types has a smaller face value, so they retain more of the surplus, and this incentivizes them to exert greater effort (i.e.,  $R_j < R_{j+1}$  leads to  $\delta_j^* > \delta_{j+1}^*$ ). However, the equilibrium effort level is below first best, since the moral hazard constraint binds.

Consider any adjacent pair,  $2j-1$  and  $2j$ . Under coarse ratings, both firms promise a repayment,  $\hat{R}$ , and choose  $\delta$  subject to the participation constraint of investors (which binds):

$$\delta^P = \arg \max (p_j + \delta)(X - \hat{R}) - \frac{\tau}{2}\delta^2 \quad (19)$$

$$\text{subject to } (p_j + \delta^P)\hat{R} - 1 = 0 \quad (20)$$

The solution of this problem is as follows:

$$\delta^P = \frac{X - \frac{1}{2}(p_{2j-1} + p_{2j})\tau + \sqrt{(X - \frac{1}{2}(p_{2j-1} + p_{2j})\tau)^2 + 4\tau(\frac{1}{2}(p_{2j-1} + p_{2j})X - 1)}}{2\tau} \quad (21)$$

Given the same repayment,  $\hat{R}$ , both firms choose the same level of effort, improving their success probability by  $\delta^P$  (independent of type). When there is pooling of two types, the lower type exerts more effort and the higher type exerts less effort than when each type gets a distinct rating, i.e.,  $\delta_{2j}^* > \delta^P > \delta_{2j-1}^*$ . The intuition is that in a coarse pool, resources are diverted from the higher type to the lower type, which negatively affects the higher type's incentives and positively affects the lower type's incentives. The subsidy that firms of type  $2j$  provide in the pool with firms of type  $2j-1$  is:

$$p_{2j}(\hat{R}_{2j,2j-1} - R_{2j}) \equiv \sigma_{2j} \quad (22)$$

In the following proposition, we characterize the equilibrium.

**Proposition 10.** Consider any adjacent pair,  $2j-1$  and  $2j$ . The net social surplus generated is higher under coarse ratings in which the adjacent types are pooled than under precise ratings. Ratings are coarse if  $\sigma_{2j} > k$ .

## 6.2. Randomization

In the baseline model, we examine equilibria only in pure strategies — the ratings policy states that all firms of a given type will obtain the same rating. In this extension, we allow for CRAs to randomize. Specifically, the policy states that all good borrowers and a fraction  $q \in [0, 1]$  of intermediate borrowers will be included in the pool, while the remaining intermediate borrowers will be identified precisely. Note that  $q = 0$  is the precise-ratings case, while  $q = 1$  is the coarse-ratings case without randomization. With  $q < 1$ , if an intermediate borrower applies for a rating and is not included in the coarse pool, it will not raise financing, and hence, not pay a fee to the CRA.

Consider the case of the monopolist CRA. The first observation is that if  $q \in (0, 1)$ , the CRA must incur the cost of precision,  $k$ . By

incurring the cost, the CRA would be able to identify an issuer to be of intermediate quality, which is a necessary step before it can randomize.

Does the monopolist CRA randomize when intermediate borrowers do not exert effort? When  $q = 0$  (i.e., ratings are precise), the full surplus is extracted by the monopolist CRA. By increasing  $q$  beyond 0, if the fee is such that intermediate borrowers do not exert effort, the net surplus shrinks for two reasons — lack of effort exertion by the intermediate borrowers, and the overall increase in the cost of precision from  $\alpha k$  (only good borrowers apply for a rating) to  $(\alpha + \beta)k$  (both good and intermediate borrowers apply for a rating). Thus, randomization (i.e.,  $0 < q < 1$ ) will not be chosen if intermediate borrowers do not exert effort.

Next we show that the monopolist CRA does not randomize when intermediate borrowers exert effort. Assuming that intermediate borrowers exert effort, for  $0 < q < 1$  and a given fee,  $f$ , the pooling interest rate becomes:

$$R_{e=1}^P(q) = \frac{(\alpha + q\beta)(1 + f)}{\alpha p_g + q\beta(p_m + \delta)} \quad (23)$$

$R_{e=1}^P(q)$  is increasing in  $q$  since the inclusion of more intermediate borrowers in the coarse pool worsens the average quality of the pool. Thus, a higher  $q$  reduces the subsidy that each intermediate borrower obtains, which tightens their effort moral hazard constraint. We derive the maximum fee such that intermediate borrowers exert effort only if the fee is below this maximum. We do this by solving  $R_{e=1}^P(q) = \bar{R}$ :

$$\bar{f}_c(q) = \frac{1}{\delta(\alpha + q\beta)} [(\delta X - c)(\alpha p_g + q\beta(p_m + \delta))] - 1 \quad (24)$$

The profit of the CRA is  $\Pi(q) = (\alpha + q\beta)\bar{f}_c(q) - (\alpha + \beta)k$ . The CRA chooses  $q$  to maximize its profits. Differentiating  $\Pi(q)$  with respect to  $q$ :

$$\frac{\partial \Pi(q)}{\partial q} = \frac{1}{\delta} [\beta(p_m + \delta)(\delta X - c) - \delta\beta] \quad (25)$$

The derivative is negative for  $c > c_s$  (which is assumed in A2), implying that the CRA's profit is falling in  $q$  and the CRA sets  $q$  as small as possible,  $q = 0$ . That is, conditional on the cost of precision having been undertaken, there is no randomization. Setting  $q = 1$  (i.e., all intermediate borrowers are pooled with good borrowers) may still be profit-maximizing because the CRA would not incur the cost of precision.

Moving to the case in which CRAs compete, allowing for randomization does not affect the equilibrium in Proposition 7. Under  $q \in (0, 1)$ , the fee is  $f = k$ , which is the marginal cost of producing the rating. From the perspective of good borrowers, this outcome is strictly dominated by the precise-ratings case since the fee would be the same in both cases, but with precise ratings the quality of the rated pool is higher and investors charge a lower interest rate. A CRA can always deviate from a  $q \in (0, 1)$  equilibrium by offering precise ratings and attracting all good borrowers. Thus, competition among CRAs would prevent randomization by CRAs.

The above discussion shows that randomization does not arise in either the monopoly or competition case. However, from the planner's perspective, it may be feasible to improve upon a precise-ratings equilibrium by implementing a  $q > 0$  policy. If  $q$  is not too large, the subsidy that the intermediate borrowers in the pool receive will be large enough to elicit effort. The planner would implement this policy when  $c > c_p$ , since for  $c \leq c_p$ , coarse ratings and low fees achieve the first best outcome.

**Proposition 11 (Optimal Randomization by Planner).** If  $c > c_p$  and  $k$  is small, the optimal outcome sets  $f = k$  and  $q$  such that the  $R_{e=1}^P(q) = \bar{R}$ :

$$q^P = \frac{\alpha p_g(\delta X - c) - \delta\alpha(1 + k)}{\beta(\delta(1 + k) - (p_m + \delta)(\delta X - c))} \quad (26)$$

The necessary and sufficient condition for randomization to be optimal is the total benefit of randomization to the economy,  $q^P \beta(p_m + \delta)(X - 1)$ , exceeds the total cost,  $(\alpha + \beta)k$ .

<sup>23</sup> Note that for  $p_j X - 1 > 0$ , as is assumed above, the smaller root is negative. Since  $\delta$  must be positive, we disregard the negative root and consider only the positive root.

**Proposition 11** implies that some degree of coarseness is optimal if  $k$  is small and regulatory intervention is necessary to obtain the socially desirable outcome. When the cost of exerting effort is high,  $c > c_p$ , a scheme of coarse ratings in pure strategies,  $q = 1$ , is always value-destroying since it allows intermediate borrowers to obtain financing, but they do not exert effort (see **Lemma 3**). In this case, a randomization policy,  $q \in (0, 1)$ , can be socially valuable if it pools a fraction of intermediate borrowers with good borrowers and it provides those intermediate borrowers with enough of a subsidy to induce effort exertion. Since the CRA does not choose a randomization policy by itself, the regulator will impose a randomization requirement of  $q = q^p$  as long as  $k$  is small enough.

## 7. Conclusion

We have presented a model of credit ratings in which coarse ratings may arise as an equilibrium outcome, and ratings precision is countercyclical. Compared to the precise-ratings case, coarse ratings introduce asymmetric information by forcing a pooling equilibrium. In existing models, the pooling generated by ratings coarseness is undesirable since it leads to inefficient investment (e.g., **Goel and Thakor 2015**). However, given the informational frictions we consider, the pooling equilibrium in our analysis can enhance net social surplus. The pooling equilibrium leads to cross-subsidization across firm types, with intermediate firms benefiting from more favorable terms due to pooling with good firms. The cross-subsidization induces intermediate firms to exert effort, when they would not have done so if their securities were accurately priced.

Thus, our model delivers “a bright side of coarseness” – coarseness can increase net social surplus even if CRAs possess the information needed to issue precise ratings. Indeed, when the cost of information production is zero, coarseness is socially desirable, even though it does not arise in the *laissez-faire* equilibrium. Although some critics of the issuer-pays model suggest that ratings coarseness may be deployed to benefit issuers at the expense of investors, our model highlights that such coarseness need not be a negative outcome from a social welfare standpoint. We show that the efficient (second best) outcome can be achieved by regulating the fee charged by CRAs. Depending on whether coarse or precise ratings are more socially desirable, the regulator would put a ceiling or a floor on the fee.

## CRedit authorship contribution statement

**Sonny Biswas:** Writing – review & editing, Writing – original draft, Formal analysis, Conceptualization. **Kostas Koufopoulos:** Writing – review & editing, Writing – original draft, Formal analysis, Conceptualization. **Anjan V. Thakor:** Writing – review & editing, Writing – original draft, Formal analysis, Conceptualization.

## Data availability

No data was used for the research described in the article.

## Appendix. Proofs

### Proof of Proposition 1.

**Proof.** The proof follows from the discussion in the text. ■

### Proof of Proposition 2.

**Proof.** Given that firm-types are observable, each type's debt is priced such that investors' participation constraint facing that type is satisfied. In order to satisfy investors' participation constraint, the interest rate offered by good firms must be  $R \geq R_g$ . Suppose that good firms obtain

financing in equilibrium at interest rate,  $R = R' > R_g$ . A good firm will deviate by offering an infinitesimally lower interest rate,  $R' - \epsilon$ , and this will be accepted by investors since they are strictly better off compared to their outside option for any  $R > R_g$ . By this argument, no interest rate other than  $R = R_g$  survives in equilibrium. Given Assumption A2 that  $c > c_s$ , the actuarially fair interest rate when intermediate borrowers exert effort,  $R_m$ , is bigger than the interest rate below which intermediate firms exert effort,  $\underline{R} < R_m$ . This implies that the investment of intermediate firms will be negative-NPV and so for any  $R \leq X$ , investors make losses. Hence, intermediate firms do not receive financing. Similarly, bad firms do not receive financing since their investment is negative-NPV and for any  $R \leq X$ , investors make losses. ■

### Proof of Proposition 3.

**Proof.** For any two interest rates,  $R$  and  $R'$ , if a good firm prefers one, the intermediate and bad firms will also strictly prefer the same interest rate. Thus, in an equilibrium without ratings, all firm-types would pool on the same contract. There are two possibilities: a pooling equilibrium with financing and a pooling equilibrium without financing (market breakdown).

We show that an equilibrium with financing cannot exist. For any interest rate,  $R < X$ , all three types of firms are strictly better off if they obtain financing, compared to the case in which they do not obtain financing. Hence, all firm-types seek financing. By Assumption A3, the expected NPV across all three firm types is negative. Thus, the contract will be loss-making for the investors, and hence, investors will not offer financing.

Consider now the case that the market breaks down in equilibrium, i.e., no firm obtains financing. A firm may deviate by offering a contract with a promised repayment,  $R < X$ . Regardless of the firm-type, this deviation, if the offer is accepted, makes the deviant firm strictly better off compared to the no-financing equilibrium. Exactly because this deviation makes all types of firms strictly better off, the Intuitive criterion does not have a bite (step 1 does not rule out any type as a potential defector), so there exists a strictly positive set of beliefs that the offer comes from a bad firm. If the deviating firm is bad, the expected payoff for the investor is negative, so such an offer will be rejected. Thus, the market breakdown equilibrium is the unique equilibrium which survives the Intuitive criterion and is consistent with zero expected profits for investors. ■

### Proof of Proposition 4.

**Proof.** Suppose that the fee is given by  $f_p = p_g X - 1 + \epsilon$ , where  $\epsilon$  may be positive or negative. Substituting in  $R_g$  (Eq. (1)), investors' participation constraint is satisfied for any  $\epsilon \leq 0$  and violated for  $\epsilon > 0$ . Additionally, the fee cannot be negative to ensure the participation of CRAs. ■

### Proof of Lemma 1.

**Proof.** It is never an equilibrium for all firm types to be given the same rating since this does not produce any information and is equivalent to the no-ratings case. Thus, from **Proposition 3**, if all firm types are given the same rating the market breakdown equilibrium is the unique equilibrium. Given that there are three firm-types, coarse ratings in our model always entail two categories and can take the following forms:

1. Good and intermediate firms are pooled together in a single category, and bad firms are in a separate category.
2. Intermediate and bad firms are pooled together in a single category, and good firms are in a separate category.
3. Good and bad firms are pooled together in a single category, and intermediate firms are in a separate category.



Option 2 is equivalent to the precise-ratings case since good firms obtain financing and neither intermediate nor bad firms obtain financing. Option 3 is equivalent to the no-ratings case. Given Assumption A4, the average NPV of the pool consisting of good and bad firms is negative, so neither good nor bad firms obtain financing under option 3. Also, intermediate firms do not obtain financing, given Assumption A2. In option 1, both good and intermediate firms may obtain financing for some parameters (e.g., if  $\beta \rightarrow 0$ , then the pool of good and intermediate borrowers is comparable to the pool of only good borrowers, and will obtain financing), which implies that this option is not equivalent to the no-ratings or precise-ratings cases. ■

#### Proof of Lemma 2.

**Proof.** With coarse ratings, the debt is priced as being issued by a pool consisting of intermediate and good firms. Suppose that intermediate firm exerts effort, i.e.,  $e = 1$ . Given a pooling interest rate,  $R_{e=1}^P$ , the zero profit condition of the investors is:

$$\frac{\alpha}{\alpha + \beta} p_g R_{e=1}^P + \frac{\beta}{\alpha + \beta} (p_m + \delta) R_{e=1}^P - 1 - f = 0 \quad (27)$$

Solving, we derive the interest rate if the ratings are coarse and intermediate firms exert effort:

$$R_{e=1}^P = \frac{(\alpha + \beta)(1 + f)}{\alpha p_g + \beta(p_m + \delta)} \quad (28)$$

If intermediate firms do not exert effort, i.e.,  $e = 0$ , then given a pooling interest rate,  $R_{e=0}^P$ , the zero profit condition of the investors is:

$$\frac{\alpha}{\alpha + \beta} p_g R_{e=0}^P + \frac{\beta}{\alpha + \beta} p_m R_{e=0}^P - 1 - f = 0 \quad (29)$$

Solving, we derive the interest rate if the ratings are coarse and intermediate firms do not exert effort:

$$R_{e=0}^P = \frac{(\alpha + \beta)(1 + f)}{\alpha p_g + \beta p_m} \quad (30)$$

#### Proof of Lemma 3.

**Proof.** The pooling interest rate,  $R_{e=1}^P$ , is consistent with the beliefs of investors that intermediate firm exerts effort if it is smaller than the incentive compatible interest rate, i.e.,  $R_{e=1}^P \leq \underline{R}$ . Assuming  $f = 0$ ,  $R_{e=1}^P \leq \underline{R}$  if:

$$c \leq \delta X - \frac{\delta(\alpha + \beta)}{\alpha p_g + \beta(p_m + \delta)} \equiv c_p \quad (31)$$

If the cost of effort is sufficiently small, i.e.,  $c \leq c_p$ , intermediate firm exerts effort if  $f = 0$  and the equilibrium with  $R = R_{e=1}^P$  exists. This implies that for  $c > c_p$ , the investors' beliefs that intermediate firms exert effort are not fulfilled which implies that the equilibrium with  $R = R_{e=1}^P$  cannot exist for any non-zero  $f$ .

Using  $c_s$  from Assumption A2 and (7):

$$\begin{aligned} c_p &> c_s \\ \Rightarrow \delta X - \frac{\delta(\alpha + \beta)}{\alpha p_g + \beta(p_m + \delta)} &> \delta X - \frac{\delta}{p_m + \delta} \\ \Rightarrow \frac{1}{p_m + \delta} &> \frac{\alpha + \beta}{\alpha p_g + \beta(p_m + \delta)} \\ \Rightarrow p_g &> p_m + \delta \end{aligned} \quad (32)$$

The above condition is always satisfied due to Assumption A2. ■

#### Proof of Proposition 5.

**Proof.** Suppose that the fee is given by  $f = \bar{f}_c + \epsilon$ , where  $\epsilon$  may be positive or negative. Substituting in the effort moral hazard constraint,  $R_{e=1}^P$  (Eq. (28)), intermediate borrowers' incentive compatibility constraint is satisfied (i.e.,  $R_{e=1}^P \leq \underline{R}$ ) only if  $\epsilon \leq 0$  and violated for  $\epsilon > 0$ . A fee lower

than  $\bar{f}_c$  makes the constraint less binding. However, the fee cannot be negative to ensure the participation of CRAs. Thus, a coarse-ratings equilibrium with effort provision by intermediate borrowers may arise if  $f \in [0, \bar{f}_c]$ . For  $\frac{\alpha}{\beta} < \gamma$ , the average NPV of the pool is negative unless intermediate borrowers exert effort, which implies that for  $f > \bar{f}_c$  the market breaks down.

For  $\frac{\alpha}{\beta} \geq \gamma$ , it is possible that there is financing even if intermediate borrowers do not exert effort, i.e., the fee is high,  $f > \bar{f}_c$ . If investors hold the belief that intermediate firms do not exert effort, i.e.,  $e = 0$ , then the pooling interest rate is  $R_{e=0}^P$ . Suppose that the fee is given by  $f = \hat{f}_c + \epsilon$ , where  $\epsilon$  may be positive or negative. Substituting in  $R_{e=0}^P$ , investors' participation constraint is satisfied for any  $\epsilon \leq 0$  and violated for  $\epsilon > 0$ . Thus, a coarse-ratings equilibrium without effort provision by intermediate borrowers may arise if  $\bar{f}_c < f \leq \hat{f}_c$ . ■

#### Proof of Lemma 4.

**Proof.** The monopolist CRA charges the maximum possible fee given the rating policy and subject to satisfying investors' participation constraints. Thus, if ratings are precise,  $f = f_p$ , where  $f_p$  is the maximum fee under precise ratings which satisfies investors' participation constraint (see Proposition 4). Under coarse ratings and for  $\frac{\alpha}{\beta} < \gamma$ , the fee must be such that intermediate borrowers exert effort,  $f = \bar{f}_c$ , where  $\bar{f}_c$  is the maximum fee under coarse ratings consistent with effort exertion by intermediate borrowers (see Proposition 5). For  $\frac{\alpha}{\beta} \geq \gamma$ , the fee is  $f = \bar{f}_c$  if  $\bar{f}_c \geq \hat{f}_c$ , and  $f = \hat{f}_c$ , otherwise; intermediate borrowers exert effort in the former case, while not in the latter. ■

#### Proof of Lemma 5.

**Proof.**  $f_p > \max(\bar{f}_c, \hat{f}_c)$  follows directly from Assumptions A1 and A2.  $\bar{f}_c > \hat{f}_c$  if  $c \leq \bar{c}$  (see Eq. (10)).  $\bar{c} > c_s$  if:

$$\beta \delta X (p_m + \delta) > (\alpha p_g + \beta(p_m + \delta))((p_m + \delta)X - 1) \quad (33)$$

$$\Rightarrow \alpha < \frac{1}{p_g} \frac{\beta \delta X (p_m + \delta) - \beta(p_m + \delta)((p_m + \delta)X - 1)}{(p_m + \delta)X - 1} \quad (34)$$

$$\Rightarrow \alpha < \frac{1}{p_g} \frac{\beta(p_m + \delta) \overbrace{(1 - p_m X)}^{>0 \text{ from A1}}}{\underbrace{(p_m + \delta)X - 1}_{>0 \text{ from A2}}} \quad (35)$$

$\alpha$  lies between 0 and 1, while the RHS is positive. The above condition is satisfied for  $\alpha$  sufficiently small. Assumptions A1 and A2 do not feature  $\alpha$ , while A3 and A4 put upper bounds on it. Thus, it is always feasible to set  $\alpha$  to be sufficiently small such that the above condition is satisfied without violating any of the parametric restrictions. ■

#### Proof of Proposition 6.

**Proof.** The monopolist CRA chooses ratings policy and fee to maximize its profits. Under precise ratings, the CRA incurs a cost,  $k$ , and only good borrowers purchase ratings. The total profit is  $\alpha(f_p - k)$ . Under coarse ratings, the CRA does not incur a cost, and both good and intermediate borrowers purchase ratings. The total profit is  $(\alpha + \beta) \max(\bar{f}_c, \hat{f}_c)$ .  $(\alpha + \beta)\bar{f}_c > \alpha(f_p - k)$  if  $k \geq k_1$  (see Eq. (11)) and  $(\alpha + \beta)\hat{f}_c > \alpha(f_p - k)$  if  $k \geq k_2$  (see Eq. (12)). In a coarse-ratings equilibrium, the CRA chooses the incentive compatible fee if  $\bar{f}_c > \hat{f}_c$  which holds if the cost of effort provision is sufficiently small,  $c \leq \bar{c}$  (see Eq. (10)).

For  $\frac{\alpha}{\beta} \geq \gamma$ , the average NPV of good and intermediate firms is positive, whether or not intermediate firms exert effort. If  $k > \min(k_1, k_2)$ , the CRA maximizes its profits by offering coarse ratings and charging a fee which depends on the cost of exerting effort: the fee is  $f = \bar{f}_c$  if  $c \leq \bar{c}$  and  $f = \hat{f}_c$  if  $c > \bar{c}$ . Rational investors hold the correct beliefs in equilibrium and set the interest rate such that they break even, on

average. Intermediate firms certainly prefer coarse ratings because they are subsidized by good firms. Regarding good firms, they are worse off with coarse ratings compared to precise ratings, but given that only coarse ratings are offered, they prefer coarse ratings to no ratings. The reason is that if a good firm chooses no rating, it will get no financing. Therefore, good firms will also purchase coarse ratings. If the cost of producing precise ratings is small,  $k < \min(k_1, k_2)$ , the CRA maximizes its profits by offering precise ratings and charging high fees,  $f = f_p$ .

If, on the other hand,  $\frac{\alpha}{\beta} < \gamma$ , coarse ratings and high fees,  $f > \bar{f}_c$  imply that there is market breakdown and no firm obtains credit. This leads to a total fee revenue and profit of 0, which is less than the profit with precise ratings or coarse ratings and low fees,  $f = \bar{f}_c$ . Hence, for  $\frac{\alpha}{\beta} < \gamma$ , the equilibrium with one CRA features precise ratings and  $f = f_p$  if  $k < k_1$  and coarse ratings with  $f = \bar{f}_c$  if  $k > k_1$ .

Finally, we need to show that there exist feasible parameters for which coarseness, with or without effort provision by intermediate borrowers, may arise. To show that coarseness with (resp. without) effort provision is feasible we need to check that  $k > k_1$  (resp.  $k > k_2$ ) are feasible without violating the upper bound on  $k$  in Assumption A1,  $k < p_g X - 1$ .

To see that parameters exist such that coarseness with effort provision arises, substitute  $c = c_s$  (this is the lower bound of  $c$  from Assumption A2) in  $k_1$ .  $k_1$  becomes:

$$k_1 = p_g X - \frac{p_g}{p_m + \delta} < p_g X - 1 \quad (36)$$

Thus, for  $c = c_s$ ,  $k_1$  is smaller than the upper bound on  $k$  since  $p_g > p_m + \delta$  (which is true by Assumption A2). Hence, there may exist  $k > k_1$  which does not violate Assumption A1. For these  $k$ , the equilibrium features coarse ratings and intermediate borrowers exert effort if  $c < \bar{c}$ .

To see that parameters exist such that coarseness without effort provision arises, consider the case  $\frac{\alpha}{\beta} \geq \gamma$  and  $c > \bar{c}$ . Assuming  $1 - p_m X = \epsilon$  (where  $\epsilon$  is positive but arbitrarily close to 0) does not violate any assumptions. Given this assumption,  $k_2 \rightarrow 0$  as  $\epsilon \rightarrow 0$ . Since the upper bound of  $k$  from Assumption A1,  $p_g X - 1$ , is strictly positive, there may exist  $k < p_g X - 1$  such that  $k > k_2$ . For these  $k$ , the equilibrium features coarse ratings and intermediate borrowers do not exert effort. ■

#### Proof of Corollary 1.

**Proof.** To prove the corollary, we need to show that  $\min(k_1, k_2) > 0$ .  $k_2$  is always positive since  $1 - p_m X > 0$  (by Assumption A1). To see that  $k_1$  is always positive, first note that  $k_1$  is increasing in  $c$ :

$$\frac{\partial k_1}{\partial c} = \frac{1}{\alpha \delta} (\alpha p_g + \beta(p_m + \delta)) > 0 \quad (37)$$

Next, we substitute in  $k_1$  the lower bound of  $c$  from Assumption A2,  $c = c_s$ .  $k_1$  becomes:

$$k_1 = \frac{p_g c_s}{\delta} > 0 \quad (38)$$

$k_1$  is positive when  $c = c_s$ . Therefore, since  $k_1$  is increasing in  $c$ , it must be that case that  $k_1$  is positive for any  $c > c_s$ . ■

#### Proof of Lemma 6.

**Proof.** The proof follows from the discussion in the text. ■

#### Proof of Proposition 7.

**Proof.** Suppose that  $k > \sigma_e$ , where  $e = 1$  if  $c \leq c_p$ , and  $e = 0$  if  $c > c_p$  and  $\frac{\alpha}{\beta} \geq \gamma$ . First, we show that precise ratings cannot be an equilibrium. Under precise ratings, firms pay a fee  $f = k$ . Suppose that a CRA deviates by offering coarse ratings and a lower fee,  $\epsilon$ , such that  $k - \epsilon > \sigma_e$ . Then, good firms find it profitable to deviate since the fall in the fee is higher than the subsidy it would provide by deviating to the coarse-ratings equilibrium, thereby eliminating the precise-ratings

equilibrium. Now we show that coarse-ratings is an equilibrium. Under coarse ratings, firms pay a fee  $f = 0$ . Suppose that a CRA deviates by offering precise ratings. The lowest feasible fee that the CRA charges is  $f = k$ . Even for this fee, a good firm is worse off with precise ratings since the increase in the fee would be higher than the subsidy it provides, i.e.,  $k > \sigma_e$ . Thus, the deviating CRA cannot attract good firms and the equilibrium sustains.

Suppose that  $k < \sigma_e$ . First, we show that coarse ratings cannot be an equilibrium. Under coarse ratings, firms pay a fee  $f = 0$ . Suppose that a CRA deviates by offering precise ratings and a fee,  $f = k + \epsilon$ , such that  $k + \epsilon < \sigma_e$ . Then, good firms find it profitable to deviate since the increase in the fee is lower than the subsidy it provides, thereby eliminating the coarse-ratings equilibrium. Next, we show that precise ratings is an equilibrium. Under precise ratings, firms pay a fee  $f = k$ . Suppose that a CRA deviates by offering coarse ratings and the lowest feasible fee,  $f = 0$ . Even for this fee, a good firm is worse off with coarse ratings since the fall in the fee would be lower than the subsidy it would provide, i.e.  $k < \sigma_e$ . Thus, the deviating CRA cannot attract good firms and the equilibrium sustains. ■

#### Proof of Corollary 2.

**Proof.** The proof follows from the discussion in the text. ■

#### Proof of Proposition 8.

**Proof.** If  $c \leq c_p$ , under perfect competition in the CRA industry, coarse ratings arise if  $k > \sigma_{e=1}$  and are characterized by effort provision by intermediate firms. If  $\min(k_1, k_2) < \sigma_{e=1}$ , then for  $k \in (\min(k_1, k_2), \sigma_{e=1})$ , monopoly features coarse ratings and competition features precise ratings.  $\min(k_1, k_2) < \sigma_{e=1}$  exists if the following condition is satisfied:

$$X > \min \left[ -\frac{\alpha((\alpha - (c(\alpha p_g + \beta(p_m + \delta)) + \delta(\alpha + \beta))/\delta)/\alpha + (\beta(p_g - (p_m + \delta)))/(\alpha p_g + \beta(p_m + \delta)))}{\beta(p_m + \delta)} \equiv B_1, \right. \quad (39)$$

$$\left. \frac{(\alpha + \beta)(p_m + \delta)}{p_m(\alpha p_g + \beta(p_m + \delta))} \equiv B_2 \right] \equiv \bar{X}_1$$

If, on the other hand, condition (39) is violated, there exists  $\sigma_{e=1} < \min(k_1, k_2)$ , implying that for  $k \in (\sigma_{e=1}, \min(k_1, k_2))$ , monopoly features precise ratings and competition features coarse ratings.

If  $c > c_p$ , under perfect competition in the CRA industry, coarse ratings arise if  $k > \sigma_{e=0}$  and are characterized by no effort provision by intermediate firms. Given that  $c > c_p$ ,  $f = \bar{f}_c$  is not feasible, i.e., we consider the case,  $k_1 > k_2$ . If  $k_2 < \sigma_{e=0}$ , then for  $k \in (k_2, \sigma_{e=0})$ , monopoly features coarse ratings and competition features precise ratings.  $k_2 < \sigma_{e=0}$  exists if the following condition is satisfied:

$$X > \frac{\alpha + \beta}{\alpha p_g + \beta p_m} \equiv \bar{X}_2 \quad (40)$$

If, on the other hand, condition (40) is violated, there exists  $\sigma_{e=0} < k_2$ , implying that for  $k \in (\sigma_{e=0}, k_2)$ , monopoly features precise ratings and competition features coarse ratings.

Next, we show through different examples that there exist feasible parameters for which each of the conditions in Eqs. (39) and (40) is satisfied.

#### Example 1:

Suppose that  $c < \bar{c}$ , implying that  $k_1 < k_2$ . Assume  $c = c_s$  and  $(p_m + \delta)X - 1 = \epsilon$ , where  $\epsilon$  is positive but arbitrarily small.  $k_1$  and  $\sigma_{e=1}$  become:

$$k_1 = \frac{p_g \epsilon}{p_m + \delta} \quad (41)$$

$$\sigma_{e=1} = \frac{\beta(p_g X - 1 - \epsilon)}{\alpha p_g X + \beta(1 + \epsilon)} \quad (42)$$

As  $\epsilon \rightarrow 0$ ,  $k_1 \rightarrow 0 < \sigma_{e=1} \rightarrow \frac{\beta(p_g X - 1)}{\alpha p_g X + \beta} > 0$ . This implies that for  $k \in (k_1, \sigma_{e=1})$ , there is coarseness with effort provision by intermediate borrowers in the monopoly case and precision in the competition case.

#### Example 2:

Assume that  $k_1 = k_2$  and  $p_g = p_m + \delta + \epsilon$ , where  $\epsilon$  is positive but arbitrarily small.  $\sigma_{e=1}$  becomes:

$$\sigma_{e=1} = \frac{\beta\epsilon}{\alpha p_g + \beta(p_g - \epsilon)} \quad (43)$$

As  $\epsilon \rightarrow 0$ ,  $\sigma_{e=1} \rightarrow 0 < k_1 = k_2 = \frac{\beta(1-p_m X)}{\alpha} > 0$ . This implies that for  $k \in (\sigma_{e=1}, k_1)$ , there is coarseness with effort provision by intermediate borrowers in the competition case and precision in the monopoly case.

#### Example 3:

Suppose that  $c > \bar{c}$ , implying that  $k_2 < k_1$ .  $k_2 < \sigma_{e=1}$  if  $X > B_2$  (see Eq. (39)). The upper bound on  $X$  comes from Assumption A1,  $p_m X - 1 < 0$  (assuming that  $\alpha$  and  $\beta$  are small enough that Assumptions A3 and A4 are satisfied). Suppose that  $p_m X - 1 = -\epsilon$ , where  $\epsilon$  is positive but arbitrarily small.  $X > B_2$  becomes:

$$X = \frac{1 - \epsilon}{p_m} > \frac{(\alpha + \beta)(p_m + \delta)}{p_m(\alpha p_g + \beta(p_m + \delta))} \quad (44)$$

$$\Rightarrow \underbrace{\alpha p_g - \epsilon(\alpha p_g + \beta(p_m + \delta))}_{\rightarrow 0 \text{ when } \epsilon \rightarrow 0} > \alpha(p_m + \delta) \quad (45)$$

As  $\epsilon \rightarrow 0$ , the above condition is satisfied, i.e.,  $k_2 < \sigma_{e=1}$  exists. This implies that for  $k \in (k_2, \sigma_{e=1})$ , there is coarseness without effort provision by intermediate borrowers in the monopoly case and precision in the competition case.

Using the same steps as above when  $c > c_p$ , it can be shown that  $k_2 < \sigma_{e=0}$  exists. This implies that for  $k \in (k_2, \sigma_{e=0})$ , there is coarseness without effort provision by intermediate borrowers in the monopoly case and precision in the competition case.

#### Example 4:

Suppose that  $c > \bar{c}$ , implying that  $k_2 < k_1$ .  $k_2 > \sigma_{e=1}$  if  $X < B_2$  (see Eq. (39)). The lower bound on  $X$  comes from Assumption A1,  $p_g X - 1 > 0$ . Suppose that  $p_g X - 1 = \epsilon$ , where  $\epsilon$  is positive but arbitrarily small.  $X < B_2$  becomes:

$$X = \frac{1 + \epsilon}{p_g} < \frac{(\alpha + \beta)(p_m + \delta)}{p_m(\alpha p_g + \beta(p_m + \delta))} \quad (46)$$

$$\Rightarrow \underbrace{\beta(p_m - p_g)(p_m + \delta)}_{-ve} + \underbrace{\epsilon(p_m(\alpha p_g + \beta(p_m + \delta)))}_{\rightarrow 0 \text{ when } \epsilon \rightarrow 0} < \alpha p_g \delta \quad (47)$$

As  $\epsilon \rightarrow 0$ , the above condition is satisfied since the LHS is negative while the RHS is positive, i.e.,  $k_2 > \sigma_{e=1}$  exists. This implies that for  $k \in (\sigma_{e=1}, k_2)$ , there is coarseness with effort provision by intermediate borrowers in the competition case and precision in the monopoly case.

Using the same steps as above when  $c > c_p$ , it can be shown that  $k_2 > \sigma_{e=0}$  exists. This implies that for  $k \in (k_2, \sigma_{e=0})$ , there is coarseness without effort provision by intermediate borrowers in the competition case and precision in the monopoly case. ■

#### Proof of Proposition 9.

**Proof.** The proof mostly follows from the discussion in the text. It remains to be shown that  $\sigma_{e=0} < k_2$  exists. Using Eqs. (13) and (12),  $\sigma_{e=0} < k_2$  simplifies as follows:

$$\alpha < \frac{\overbrace{(\alpha p_g + \beta p_m)(1 - p_m X)}^{>0 \text{ from A1}}}{p_g - p_m} \quad (48)$$

$\alpha$  lies between 0 and 1, while the RHS is positive. The above condition is satisfied for  $\alpha$  sufficiently small. Assumptions A1 and A2 do not feature  $\alpha$ , while A3 and A4 put upper bounds on it. Thus, it is always feasible

to set  $\alpha$  to be sufficiently small such that the above condition is satisfied without violating any of the parametric restrictions. ■

#### Proof of Corollary 3.

**Proof.** The proof follows from the discussion in the text. ■

#### Proof of Lemma 7.

**Proof.** Taking the derivative of  $\delta_j^*$  with respect to  $p_j$ , we obtain:

$$\frac{\partial \delta_j^*}{\partial p_j} = -\frac{1}{2} + \frac{1}{2} \frac{X + p_j \tau}{((X + p_j \tau)^2 - 4\tau)^{0.5}} \quad (49)$$

The derivative is positive if:

$$X + p_j \tau > ((X + p_j \tau)^2 - 4\tau)^{0.5} \quad (50)$$

$$\Rightarrow (X + p_j \tau)^2 > (X + p_j \tau)^2 - 4\tau \quad (51)$$

$$\Rightarrow \tau > 0 \quad (52)$$

This condition is always satisfied. Hence,  $\delta_j^*$  is increasing in  $p_j$ . ■

#### Proof of Proposition 10.

**Proof.** The surplus generated by a firm of type  $j$  under precise ratings is  $U^*_j$ .

$$U^*_j = (p_j + \delta_j^*)X - 1 - \frac{\tau}{2} \delta_j^{*2} \quad (53)$$

Moving from precise to coarse ratings, a transfer from the higher to the lower type implies that firms of type  $2j - 1$  (the lower type in the pooling) exert a higher effort,  $\delta^P > \delta_{2j-1}^*$ , while firms of type  $2j$  exert a lower effort,  $\delta^P < \delta_{2j}^*$ . However, given the convexity of the cost function, for any given transfer, the increase in  $\delta$  for the lower type would exceed in absolute terms the fall in  $\delta$  of the higher type. Thus, the average  $\delta$  increases, while remaining lower than the first best level (since the moral hazard constraint binds). This implies that coarseness leads to a higher net social surplus. If  $\sigma_{2j} > k$ , then in the unique equilibrium, firms of type  $2j - 1$  and  $2j$  are pooled together through coarse ratings. A further coarsening of ratings is not feasible due to competition among CRAs. ■

#### Proof of Proposition 11.

**Proof.** The proof follows from the discussion in the text. ■

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