

RATINGS ARBITRAGE AND STRUCTURED PRODUCTS

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ABSTRACT

This paper examines the criteria used by credit rating agencies when they rate structured products. We assume that some investors use credit ratings as a basis for valuing products. This leads to a necessary condition for a credit ratings criterion to be arbitrage-free. We find that the criterion used by S&P and Fitch does not satisfy the condition and explain that this criterion could have misled investors when subprime mortgages were being securitized.