



Good news, bad news and rating announcements: An empirical investigation [☆]

Koresh Galil ^{a,*}, Gil Soffer ^b

^a Department of Economics, Ben-Gurion University, P.O. Box 653, Beer-Sheva, Israel

^b Commerzbank AG, Kaiserplatz, 60261 Frankfurt am Main, Germany

ARTICLE INFO

Article history:

Received 15 February 2010

Accepted 25 April 2011

Available online 29 April 2011

JEL classification:

G14

G24

D8

Keywords:

Credit Default Swaps

Credit risk

Credit rating

Event study

ABSTRACT

In this paper we employ a new approach to test the contribution of information in rating announcements. This is the first study to test and corroborate how the CDS market responds to rating actions after controlling for the presence of concurrent public and private information. We show that since the clustering of rating announcements characterizes economically significant developments, the common practice of using “uncontaminated” samples underestimates market response. As in previous studies, we find that the market response to bad news is stronger than to good news. Nevertheless, bad news and negative rating announcements tend to cluster. Therefore, the residual contribution of negative rating announcements is small and in some cases insignificant. Positive rating announcements are less frequent and less clustered, though their residual contribution is still significant.

© 2011 Elsevier B.V. All rights reserved.

1. Introduction

Rating agencies are major sources of financial information. Credit ratings are widely used in portfolio management, asset pricing and risk management. Nonetheless, the added value of ratings has been subject to repeated examination. The criteria used by rating agencies to make changes in ratings are quite stringent, and rating agencies often seem to react to new developments slowly, leading to allegations that ratings do not provide any new information. In response, rating agencies have argued that their criteria not only aim for appropriate timing but also for stability (Loeffler, 2005), so that ratings are only changed when a reversal of the change is unlikely. Although Altman and Rijken (2004) empirically showed how rating agencies attempt to manage the tension between timeliness and stability, the issue of the information content of ratings still remains an open question because ratings are still required to be instrumental even if they are not up-to-date. In their dual targeting of both timeliness and stability,

rating agencies are expected to use information not already available on the markets.

The skepticism surrounding the information relevance of credit ratings has yielded numerous studies that have tested the market response to announcements by rating agencies. The earliest studies in the 1970s used bond and stock prices (e.g., Katz, 1974; Grier and Katz, 1976; Weinstein, 1977). More recent studies using Credit Default Swap (CDS) data, such as those by Hull et al. (2004), Norden and Weber (2004), and Micu et al. (2006), indicate that this research question is of ongoing interest. The large number of studies on this topic evidences the difficulty in reaching conclusive results. The main methodological challenge is to differentiate between market responses to the various sources of information, such as rating announcements, news in the public media and private information. Rating announcements by one rating agency are normally contaminated; i.e., they are accompanied by similar announcements by other rating agencies or by the release of related information in the public media. Hence, the abnormal behavior of markets surrounding a rating announcement cannot be exclusively connected to the rating announcement itself. Since Pinches and Singleton (1978), the use of uncontaminated events – rating announcements not preceded by or followed by another rating announcement within a certain time window – has become the standard. Holthausen and Leftwich (1986) were the first to exclude other types of contamination by excluding from their analysis rating announcements accompanied by a related article in the *Wall Street Journal* (WSJ). This approach was subsequently

[☆] The authors thank to Bogdan Stacescu, an anonymous referee and the editor for very constructive comments. We also thank seminar participants in Ben-Gurion University, Management College, Interdisciplinary Center Herzliya, 2010 conference of MFS in Barcelona for valuable comments and suggestions. A previous version of this paper was titled “The conditional response of CDS markets to rating announcements”.

* Corresponding author. Tel.: +972 8 6472310; fax: +972 8 6472971.

E-mail addresses: galilk@bgu.ac.il (K. Galil), gil.soffer@commerzbank.com (G. Soffer).

adopted in the literature. Nevertheless, recent studies using CDS data have abandoned this approach and only omit events contaminated by other rating announcements. Hence, to date research has not shown whether the CDS market response to ratings announcements can be exclusively related to rating actions rather than to contemporaneous public or private news. In this paper we address this question.

We also examine two methodological problems in the practice of using uncontaminated samples. First, we examine whether this practice creates selection-biased results, since uncontaminated events may reflect insignificant economic developments. Second, we consider residual contamination. Previous studies that used the WSJ as a proxy for public media have offered only an imperfect solution to the contamination problem, since contamination from other sources of private and public information may still be present. Creating a pure uncontaminated sample seems impossible, and so-called uncontaminated samples are in fact pseudo uncontaminated samples. The product of these two methodological drawbacks is mixed. Market response to rating announcements may be underestimated because of the selection bias and overestimated due to residual contamination. Hence, analysis of pseudo uncontaminated samples may be inconclusive.

Kliger and Sarig (2000) overcame these methodological problems by analyzing a special rating refinement event carried out by Moody's in 1982. This event was a pure uncontaminated rating event with no selection bias. Nevertheless, ongoing developments in the financial markets, information technology and rating practice have restored the question of rating information content. In this paper, we tackle the aforementioned methodological problems by applying a new approach that resembles the "difference in differences" approach. We base our conclusions on comparisons of various conditional events, for which we test two hypotheses. Our first hypothesis is that uncontaminated rating announcements reflect corporate developments that are of lower economic importance and that the use of uncontaminated samples therefore results in selection bias. Our second and major hypothesis is that ratings convey new information to the market; i.e., the market responds to rating announcements per se even after contemporaneous flows of public and private news are controlled.

We also explore the question of the asymmetric responses of markets to rating announcements. Previous studies have shown that negative announcements draw greater market response than do positive announcements, despite the fact that negative announcements are more frequent. We test whether this asymmetry can be related to the different ways in which bad news and good news flow into markets.

Our database consists of CDS spreads of 2152 entities for the period from January 1, 2002 until June 30, 2006. We analyze 2866 announcements by Moody's and S&P and also control for announcements by Fitch. Our approach conformed to that of Hull et al. (2004) and of Norden and Weber (2004), who employed a standard event study methodology using adjusted changes in credit spreads. To minimize selection bias in our sample, we only exclude events without sufficient observations on CDS spreads. Our database is at least three times larger than samples used in previous studies.¹ The changes in spreads appear to be highly skewed and to diverge from normal distribution. Hence, we base our conclusions primarily on non-parametric tests.

Our results are as follows. First, we reaffirm the findings of previous studies that used uncontaminated events, i.e., that all types of rating announcements result in abnormal adjusted spread

changes. Then we show that adjusted spread changes are greater in announcements that were followed by other rating actions. This result confirms our first hypothesis that the clustering of rating actions points to the economic significance of underlying developments. We also conclude that analyses of uncontaminated rating actions may lead to underestimation of the market's response to rating announcements.

To test our second hypothesis we assume that the flow of contaminating news into the CDS market is stationary throughout the period from 4 days prior to the event until 1 day after it. We consider this to be a conservative assumption, since rating agencies are normally alleged to follow financial markets rather than lead them. Then we measure the difference between the adjusted spread changes over two time intervals: from 1 day prior to the event until 1 day after it, and from 4 days prior to the event until 2 days prior to the event. If rating announcements convey new information, this measure should be different from zero. A major advantage of this approach is that it can control for all types of public and private information. Indeed our results show that rating announcements do convey new information. However, rating changes following reviews do not convey significant information. More interestingly, downgrades following rating actions by other agencies also do not convey new information, especially when compared to negative reviews. This finding is consistent with the findings of Norden (2008) regarding greater early media coverage of firms undergoing downgrades.

We suggest the following explanation for our results. Overall market response to negative news is stronger than to positive news. We conjecture that rating agencies tend to address this higher demand for negative information through higher rates of downgrades and negative reviews (compared to upgrades and positive reviews). Nevertheless, this tendency to release negative news also reflects other information providers. Hence, bad news that includes downgrades and negative reviews tends to cluster. While changes in spreads are greater surrounding the release of bad news, the residual contribution of a single negative rating announcement may be insignificant. On the other hand, while good news has a lesser effect on the market, it is also more infrequent than bad news. Therefore, the residual contribution of a single positive rating announcement is still significant.

The remainder of the paper is organized as follows. Section 2 provides a literature review, and Section 3 describes the data and methodology. Section 4 presents the results, and Section 5 concludes.

2. Literature review

The various studies that have tested market response to rating announcements differ on three main issues: market of response, type of announcements and degree of controlling for other types of information. The earliest studies in this field – Katz (1974), Grier and Katz (1976), Hetttenhouse and Sartoris (1976) and Weinstein (1977) – used bond returns to test market response to rating changes, with no control for contamination. Considering the absence of any control for contamination, the results of these studies were surprising: no response to rating changes.²

Pinches and Singleton (1978) were the first that not only used stock data but also considered contamination. They used a sample of rating changes by Moody's that were not preceded by any other change in the 18 months prior to the event and not followed by any other change in the 12 months following the event. Their findings showed market anticipation but no response to rating changes.

¹ Previous studies use 217 (Hull et al., 2004), 279 Norden and Weber (2004), 954 (Micu et al. 2006), 608 (Norden, 2008) events of rating changes and rating reviews. Hull et al.(2004) and Micu et al. (2006) also analyze events of changes in rating outlook.

² An exception is the finding of Grier and Katz (1976) regarding the market response to rating changes of industrials compared to utilities.

Download English Version:

<https://daneshyari.com/en/article/5089947>

Download Persian Version:

<https://daneshyari.com/article/5089947>

[Daneshyari.com](https://daneshyari.com)