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## Article

# Effect of signals of bank ratings on stock returns before and during the financial crisis

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## ABSTRACT

This paper analyses the effect of rating signals on banks' stock market returns during the period 2004–2012. The results obtained show that investors respond to rating announcements. Specifically, it is found that before the financial crisis, positive rating signals issued by Standard and Poor's and Moody's, and negative ratings signals issued by Fitch and Standard and Poor's, have a significant effect on the return on banks' shares. Conversely, in a context in which the banks experienced a significant worsening of their financial situation and the rating agencies were in the spotlight, investors reacted not only to rating downgrades as expected, but also to rating upgrades. Furthermore, the results suggest that investors do not react with the same intensity to the ratings signals issued by the rating agencies. Analysis of the causal relationship between rating signals and returns on banks' shares indicates that the policies of the rating agencies are not totally independent of changes occurring in the financial markets.

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## 1. Introduction

The subprime crisis of 2007 in the United States and the subsequent sovereign debt crisis in the European Union have again reopened the debate over the role of rating agencies and the excessive impact of their ratings on the financial markets. In this context, as reflected by the [Financial Crisis Inquiry Report \(2011\)](#) and [Benmelech and Dlugosz \(2010\)](#), during the subprime crisis the agencies were accused of relaxing their rating criteria in evaluating structured products. Furthermore, during the sovereign debt crisis in Europe the rating agencies were criticised for their inaccurate downgrading of the sovereign ratings of the countries with financial problems ([IMF, 2010](#)). At the same time, the agencies were also criticised for the conflicts of interest deriving from their business model, their lack of transparency, and the excessive credibility they received from investors and regulators ([Bank of England, 2011](#)).

Regulators, concerned about the systemic risks that may be caused by changes in ratings during times of financial instability, carried out various regulatory reforms. In 2008, the International Organisation of Securities Commissions (IOSCO) revised its code of conduct with the aim of increasing transparency, independence and competition among the rating agencies. In 2009, the

European Parliament passed a new regulation (Regulation (EC) No 1060/2009) compelling agencies operating in Europe to register with the Committee of European Securities Regulators. Subsequently, in July 2011, this competence was transferred to the European Securities and Markets Authority (ESMA). In 2009 the United States Securities and Exchange Commission also imposed restrictions aimed at avoiding conflicts of interest between rating agencies and issuers, demanding greater diffusion of the statistics on ratings performance, and increasing the transparency of rating methodologies. In light of these reforms in Europe and the United States, the Basel Committee reviewed the role of ratings in the calculation of regulatory capital. Other G-20 countries also reformed their regulations to tighten supervision of the rating agencies. Finally, the Financial Stability Board published a set of principles ([FSB, 2010](#)) to reduce the excessive reliance of investors, regulators and other agents on the rating agencies.

Despite the criticisms received and the succession of regulatory reforms described above, ratings continue to have a significant effect in the financial markets ([Bank of England, 2011](#)). Although the effect of rating announcements (i.e. signals) on the financial markets has been amply discussed in the literature on sovereign ratings, very few studies analyse this question for the case of banks' issuer ratings. Notable papers on sovereign ratings include [Kaminsky and Schmukler \(2002\)](#), [Brooks et al. \(2004\)](#), [Martell \(2005\)](#), [Ferreira and Gama \(2007\)](#), [Arezki et al. \(2011\)](#), [Hill and Faff \(2010\)](#) and [Afonso et al. \(2012\)](#). All these studies find that while rating downgrades

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have a significant effect on the stock and bond markets, rating upgrades have a limited effect.

The present paper, to the best of our knowledge, is the first study to analyse the effects of rating announcements for banks in the European Union on the returns of their shares for a period covering a full economic cycle. To analyse this question, the study uses changes in bank issuer ratings and their short- and long-term perspectives, namely watchlists and outlooks, awarded during the period 2004–2012 by the three principal rating agencies: Standard and Poor's, Moody's, and Fitch. Furthermore, unlike previous research that focuses on the effect of ratings signals during the financial crisis, this paper explores not only the negative rating signals (i.e. rating downgrades and negative perspectives), but also the positive signals (i.e. rating upgrades and positive perspectives). In addition, the long period considered allows analysis of how the financial crisis and the changes in market sensitivity impact ratings signals. Furthermore, the reverse causation is also analysed, that is, whether rating agencies react to markets in their rating policies.

The results obtained show how investors modify their investment strategies in accordance with rating signals. Specifically, the results suggest that before the financial crisis, positive rating signals issued by Standard and Poor's and Moody's, and negative ratings signals issued by Fitch and Standard and Poor's have a significant effect on the returns on banks' shares. On the other hand, with the worsening of the banks' asset situation during the crisis (*Financial Stability Report of the European Central Bank, 2008a,b*) and the criticisms levelled against the agencies, their negative signals of banks' issuer ratings have a significant effect on share returns. Similarly, the rating upgrades also have a significant effect, even higher than downgrades, as investors are less likely to expect upgrades during a period of financial distress. Lastly, it should be highlighted that the different effect of ratings on banks' share returns suggests that investors react differently to the agencies' ratings announcements.

In addition, regarding the hypothesis of whether rating agencies also follow stock market fluctuations when deciding their ratings, the results suggest that the rating policies are not totally immune to the variations occurring in the financial markets. Therefore, the findings suggest that the ratings agencies do not strictly follow a "through-the-cycle" strategy, as claimed in their methodological reports (e.g. *Moody's, 2007a,b*) and by some authors in the literature (e.g. *Altman and Rijken, 2004, 2006*). However, it should be highlighted that with the onset of the financial crisis the rating agencies reacted to a lesser extent to changes in the stock markets. In addition, the results also suggest that the reactions to the previous changes in the stock markets vary according to the rating agency analysed.

The rest of the paper is structured as follows. Section 2 briefly reviews the literature on the influence of rating announcements on the stock markets. Section 3 describes the sample and performs a descriptive analysis of ratings behaviour during the period of analysis. Section 4 describes the methodology used both in analysing events (rating signals) and in studying the causal relationship between the changes in ratings and abnormal stock returns. Section 5 reports the empirical results. Finally, the conclusions are presented.

## 2. Review of the literature

### 2.1. Effect of sovereign rating signals on the financial markets

A large number of studies analyse the effects of rating changes on bond and stock markets. However, most of the studies analysing the impact of rating signals on the financial markets have focussed on sovereign ratings, while very few have analysed this question exclusively for the case of banks. Outstanding studies of sovereign

ratings include *Brooks et al. (2004)*, who examine the effect of rating signals on the returns of the national stock markets. *Gande and Parsley (2005)* study the effect of change in the sovereign rating of a country on the sovereign credit differentials of other countries (spillover effect). In particular, these authors find evidence that sovereign rating downgrades trigger cross-border effects. *Ferreira and Gama (2007)* examine the spillover effects of sovereign ratings on international stock market returns. *Afonso et al. (2012)* analyse the effect of sovereign rating signals on bond yields, stock markets and the sovereign credit default swap spreads of the European Union countries. All these studies find evidence that only negative rating signals have a significant effect on the financial markets. This suggests that governments tend to advance positive information to the financial markets on their financial situation, while they are reluctant to advance information of a negative character.

More recent studies such as *Arezki et al. (2011)* show that the spillover effect analysed by other studies in the literature depends on the type of rating awarded, on the country in which the downgrade occurs, and on the rating agency that issues the rating signal. These authors found that negative signals of ratings which are close to the speculative grade have a systematic spillover effect among the Eurozone countries. This shows that the effect of rating signals increases as the credit quality of the entities evaluated diminishes.

*Hill and Faff (2010)* show that of the three main rating agencies, Standard and Poor's issues most rating signals and their ratings have the greatest impact on the stock markets. This study finds that outlooks and watchlists have a greater influence than rating changes themselves on the returns on shares, and shows that the reaction of the financial markets is more intense during periods of economic crisis. Finally, these authors, who also study lead-lag relationships among agencies, find evidence that Standard and Poor's is the leading agency in non-advanced economies, while Moody's leads in advanced economies.

In another recent study, *Caselli et al. (2014)* analyse the spillover effect of Eurozone sovereign rating changes on domestic bank share prices in the period 2002–2012, considering the effect of the recent financial crisis. These authors find evidence of the strong negative spillover effect of sovereign rating changes on bank share prices in the case of downgrades, but no significant effect in the case of upgrades. This result shows that stock returns after downgrades are significantly negative, but insignificant in the cases of upgrades.

In the same line, *Correa et al. (2014)* analyse the effect of the sovereign rating changes on bank stock returns in 37 countries during the period 1995 and 2011. These authors found evidence that sovereign rating downgrades have a large negative effect on bank stock returns for those banks that could receive stronger support from their corresponding governments. Thus, these results suggest that the risk of the governments and domestic banks are significantly connected.

Finally, *Alsakka et al. (2016)*, analyse the differences of opinion in sovereign ratings issued by the three main rating agencies and their effect on the main European stock markets during the recent financial crisis. Their results show that the investors only react significantly to negative rating signals issued by Standard and Poor's. Additionally, these authors find evidence that market responses are affected by disagreements between Standard and Poor's, Fitch and Moody's. Finally, these authors, find evidence that only negative rating signals issued by Standard and Poor's affect the own-country stock market and spill over to other European markets.

### 2.2. Effect of the bank rating signals on the financial markets

Few papers have dealt with the effect of bank ratings on the stock market. *Schweitzer et al. (1992)* examine the impact of rating changes on bank share prices in the United States. The results show that both positive and negative rating signals have a significant

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