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Financial institution credit assessment and implications for portfolio managers

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ABSTRACT

We document systematic industry differences between the yields of bonds issued with the same credit rating. Specifically, financial firm bonds provide higher yields after controlling for issue and firm-specific characteristics. An exception is the debt of large financial issuers, consistent with the too-big-to-fail phenomenon. Evidence of higher yields extends to syndicated loans but does not translate to abnormal returns in secondary bond market trading when returns are explained by a four factor model. Our results suggest that portfolio managers could use financial institution bonds to generate greater yield within their rating constraints but doing so may increase exposure to risk.

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1. Introduction

Portfolio guidelines and investment policy statements allow investors to communicate to portfolio managers their overall return objectives and appetite for risk. By necessity, these guidelines need to be general enough to cover a wide range of possible assets and communicate objectives in a relatively concise way. Standardized tools have helped to facilitate this communication and for fixed income portfolios, the most common of these is credit ratings. [Cantor et al. \(2007\)](#) document that close to 80% of portfolio managers and fund sponsors explicitly rely on credit ratings in their portfolio guidelines.

In this paper we explore the mapping between rating categories assigned to a bond at issue and the yield that is ultimately required by investors. In particular, we ask whether there are industry differences in the yields required for bonds that are assigned the same credit rating. Portfolio guidelines, financial regulations, and rating agencies themselves generally make no distinction across industries, treating a bond rated “A” as bearing the same amount of risk as a similarly rated bond, regardless of the issuer's industry.³ Yet, if ratings are noisy or imperfect assessments of how investors view the risks of a

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³ This is generally the case for both issue and issuer ratings, however there are a small number of cases in which a rating agency may provide a separate category of rating that is particularly relevant for firms in that industry. Examples include ratings with the designation “F” issued by S&P to assess the creditworthiness of a fixed income portfolio or “Insurer Financial Strength” ratings designed to assess the ability of an insurer to meet policy obligations rather than debt obligations.

particular industry, systematic differences may exist in the yield required for bonds within the same rating category. These differences may allow a portfolio manager to introduce higher yielding bonds into their holdings while remaining within their set rating constraints. As suggested by Becker and Ivashina (2013) this additional yield may be particularly attractive during extended periods of low interest rates.

The specific industry comparison we focus on in this paper is the yield on bonds issued by financial institutions versus non-financial firms. We are motivated to focus on the finance industry for several reasons. First, financial firms are frequent issuers of debt. In our sample, covering the years 1967–2012, approximately 40% of public bonds are issued by financial firms. The sheer number of issues by this industry makes understanding the determinants of yield particularly relevant and implies that it would be hard for a fixed income portfolio manager to avoid investing in this debt. Second, previous research has documented a higher degree of noise in the credit assessments assigned to banks than other firms. Greater uncertainty around financial institution credit ratings evidenced by Morgan (2002) and Iannotta (2006) and the possibility of rapid rating changes within the industry (S&P, 2010) imply less precision in assigning rating categories to these firms. Finally, unique features of this industry may make credit assessment more difficult. For instance, the assets of these institutions may include the loans of opaque firms (Diamond, 1984), have complex payoff structures, and be insufficiently disclosed (Barth and Landsman, 2010; Laux and Leuz, 2010). Measuring credit risk may be further hampered by the lack of consensus on the definition of broader systemic risks faced by the finance industry and appropriate ways to quantify them (Schwarcz, 2008; Hansen, 2013).

While previous work has documented difficulties in accurately assessing the risk of financial institutions, we ask whether this translates into systematic yield differences when compared to the debt of non-financial firms with similar characteristics. In particular, we suggest that this added uncertainty and the propensity for financial firms to experience sudden and dramatic changes in credit quality, may lead investors to ask for higher levels of yield than what the rating would typically imply.

To be clear, it is not our suggestion that the *determinants* of ratings are the same across all industries nor is it necessary that we understand precisely what these determinants are. What is important is that the output, specifically the rating assigned, is used by investors in a consistent way across all industries. This underlying assumption of consistency is made explicit by Standard and Poor's (S&P) stating that one objective of a recent revision to bank rating methodology was to ensure that the ratings maintained their comparability with other industries (S&P, Request for Comment: Banks Rating Methodology, January 6, 2011).

Further emphasizing the consistent interpretation of credit ratings has been their traditional use in regulation and portfolio guidelines. While the Dodd–Frank Act called for a review of the use of ratings in formal regulation, the results of these reviews have only recently been implemented.⁴ Traditionally, the level of capital required to back non-convertible debt held by broker-dealers depended on whether two rating agencies placed the debt within their highest four rating categories. No distinction was made for differences in the characteristics of the firms issuing the debt once rating standards were met. Similarly, mortgage-backed securities (MBS) that were rated AAA by rating agencies were interpreted by portfolio managers to meet the highest level of credit quality, leading investors to lose millions once it became clear that significantly greater risks were associated with these securities (Benmelech and Dlugosz, 2009). Clearly determinants of ratings for MBS, bank bonds, and other non-convertible debt differ, however once ratings are assigned, they are used in a standardized way regardless of issue or issuer characteristics.

We begin our analysis by looking for motivating evidence that financial institution credit quality may be both difficult to assess and prone to sudden change, such that investors may require higher yields on the debt of these firms as compensation for greater uncertainty. We do so by examining changes in S&P credit ratings for approximately 1600 defaulted firms, including 161 financials, in the five years prior to their eventual default. This analysis provides evidence of rapid change in the credit assessment for financial firms and the tendency for ratings to be able to anticipate default far earlier for non-financial firms.

With this evidence as motivation, we move to examine whether there are differential yields at the time of issue between the bonds of financial institutions and those of similarly-rated non-financial firms. We find systematically higher yields for financial institution bonds even after controlling for observable issue-specific and firm features. In addition, the higher yields exist throughout our entire sample period, are not driven by years surrounding the 2007–2009 financial crisis, and are not a function of ratings assigned by a single rating agency. An analysis of the syndicated loan market also finds higher yield requirements for debt issued by financial firms. Our results are consistent with Iannotta (2011) whose analysis of spread dispersion suggests that investors look well beyond easily observed characteristics such as rating, maturity and seniority when pricing the bonds of opaque banks.

Following the method employed by Becker and Ivashina (2013), we then examine excess returns generated by secondary market trades for financial institution bonds. Applying an asset pricing model to the time series of returns generated by these bonds provides no evidence that financial institution bonds generate abnormal levels of excess return. Yields provided through secondary market trades appear appropriate given standard fixed income pricing models accounting for the default premium, term spread, market risk premium, and a liquidity factor. Overall, our results suggest that buying and holding to maturity a portfolio of financial institution bonds provides higher average yield than a portfolio of similarly rated

⁴ For example, a revised Securities Exchange Act of 1934 in which several references to credit ratings were removed was implemented in July, 2104. A full detail of these revisions is available at: <http://www.sec.gov/rules/final/2013/34-71194.pdf> (accessed February 24, 2015).

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