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Usefulness of earnings in credit markets: Korean evidence☆

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ABSTRACT

This study examines both credit default swap (CDS) and bond markets to test the value relevance of earnings information. Using a sample of firms listed on the Korea Exchange (KRX) from the fourth quarter of 2007 to the fourth quarter of 2012, we find that earnings are value relevant in the long window for both CDSs and bonds. However, in the short window, earnings information is impounded into CDS premia but not into bond spreads. This supports prior studies that find timelier price discovery in CDS markets compared with bond markets. In addition, we provide evidence that earnings information is more useful in pricing both CDSs and bonds during the financial crisis. Overall, our findings suggest that earnings provide useful information to the credit market and that the extent of its usefulness depends on the type of credit product and market conditions.

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1. Introduction

This study examines and compares the usefulness of earnings in pricing both credit default swaps (CDSs) and corporate bonds for a set of Korean firms listed on the Korea Exchange (KRX). Prior studies document that

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earnings convey information related to credit risk (Altman, 1968; Ohlson, 1980; Zmijewski, 1984). A firm's current profitability, that is, its current earnings, predicts its future cash flows (Dechow, 1994; Finger, 1994). Therefore, for creditors, an increase in earnings implies a higher probability of receiving scheduled payments or, alternatively, a lower probability of default. Credit risk related information in earnings is also supported by a theoretical model by Duffie and Lando (2001) that explains how accounting information plays a role in pricing credit market instruments. Based on the prior literature and investment practices, we consider earnings as a sufficient summary measure of accounting information conveying credit risk.

If earnings contain information on credit risk, credit market investors will respond to earnings and the information will eventually be impounded into the prices of credit market instruments. The corporate bond and CDS markets are the two different credit markets we choose to examine the credit risk information in earnings. The corporate bond is the most common classical credit instrument which pays interest at regular intervals and the principal at the maturity date. The CDS is a credit derivative which provides bond investors with insurance against possible credit events (e.g., bankruptcy) of reference entities (bond issuers). CDS sellers require a premium to compensate for taking the credit risk on behalf of CDS buyers. The price of a CDS is called the CDS premium, which is quoted in basis points of the contract's notional principal amount per annum. The higher the credit risk, the larger the CDS premium will be. The CDS and bond markets are closely related because a CDS is a credit derivative for which a corporate bond issued by the reference entity is the underlying asset. Therefore, it would be interesting to examine how two closely related markets react to the earnings of the same set of firms.

We choose the Korean CDS and bond markets because these markets contrast with those of developed countries such as the U.S. in several important aspects, providing an interesting setting to examine the credit relevance of earnings in a non-U.S. country. First, the Korean CDS market has been growing fast, especially in the late 2000s, with the support of the Korean government. In terms of the issue amount, the average annual growth rate in the Korean CDS market for 2007–2011 was approximately 65%, while the average annual growth rate in the global CDS market was −13% per year for the same period (BIS: http://www.bis.org/). Second, the Korean bond market has low liquidity. If the trading volume is low in the bond market, earnings may not be impounded into bond spreads in a timely manner. Furthermore, Korea has relatively low accounting transparency compared with financially developed countries (Bhattacharya et al., 2003; Leuz et al., 2003). It is unclear whether credit investors still respond to less transparent earnings information.

Easton et al. (2009) present initial evidence on the role of accounting earnings in the U.S. corporate bond market, finding that earnings convey credit information to the bond market. Regarding the CDS market, Callen et al. (2009) document that CDS premia are negatively related with the earnings of U.S. reference entities. They show the impact of earnings on pricing credit risk in the CDS market using short- and long-window analyses. These studies only explore the usefulness of earnings separately for bond and CDS markets. We extend prior studies by examining the role of earnings in CDS premia and bond spreads for the same set of Korean firms.

A natural question arising from our study is whether credit market conditions affect the usefulness of earnings for investors. The role of earnings in credit pricing is likely to vary depending on market conditions. Bond holders and CDS sellers receive only fixed payments when the underlying firm performs well, while their loss is huge when a credit event occurs. To the extent that earnings are useful in pricing both CDSs and bonds, we expect that the impact of earnings will be an increasing function of the likelihood of credit events given the asymmetric payoff of CDSs and bonds. Thus, we predict that earnings are more useful to credit investors during the financial crisis.

To investigate the role of usefulness of earnings in credit markets, we conduct both a short-window test and a long-window test.[2,3] Specifically, we examine the short-window market reaction by regressing changes in CDS premia (bond spreads) over three days centered on the quarterly earnings announcement date on earnings surprises. The short-window test allows us to tell how investors react to earnings announcements.

[2] To show whether accounting information affects security prices, numerous studies have used both the short-window test and the long-window test together (Callen et al., 2009; Easton et al., 2009; Soliman, 2008; Wahlen, 1994). See Kothari (2001) for a good summary of the use of each test in the accounting literature.

[3] In general, there are two types of long-window test: a level test and a change test. Although most of the prior studies conducted a level test, we do a change test because Callen et al. (2009) note that CDS premia are stationary in terms of changes but not in levels and they conducted a change test. We also conduct a level test, and in an untabulated analysis, we find that the results are qualitatively similar to those of the change test.

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