The Informational Content of Credit Rating Announcements Before and During the Financial Crisis

Master Thesis

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Executive Summary

First credit rating agency was established in 1909 by John Moody in USA. For over a hundred years they are the major source of information in the financial markets. They play an important role for many economic agents. Their task is to assess the creditworthiness of the issuer and communicate it to the investors in order to reduce the information asymmetry between the market participants and rating issuers. Through regulations and statutes the importance of credit rating agencies increases. The ratings are very important factor in assessing the capital requirements of financial institutions and in the process of making investment decisions. The rating industry is developing very rapidly.

However the recent financial crisis and other events such as Enron's bankruptcy started a debate about the performance of rating industry and their potential contribution to the turmoil in credit market. The 'Issuer Pays' business model of rating agencies arises some doubts in the objectivity of their services. On July 10, 2007 two major credit rating agencies: Standard and Poor's and Moody's announced that they will downgrade or put on the negative review almost 1 000 securities with the original face value of over \$ 10 billion.

The numerous studies contributed to examination of informational content of credit rating announcements. They investigated the investors' reaction to different types of credit rating announcements. However not many studies have had an opportunity to analyze the informativeness of rating announcement during the recent financial crisis. This thesis contributes to this research field.

The informational content of actual credit rating changes and listing the watchlist before and during the crisis is examined. It consists of three major parts. First of all the overview about the history and current situation of the rating industry as well as daily business and competition is presented. This allows a better understanding of how the credit rating agencies operate. The detailed description of related literature and theory follows. The second part of the thesis focuses on empirical analysis of investors' reaction to the rating events. The daily stock price returns of US companies are examined. The sampled firms are present in different sectors and can be distinguished by different market capitalization. The data sample covers the time period from January 2004 to December 2011. It examines the price impact of uncontaminated credit rating announcements. The event study methodology is applied to analyze the abnormal stock returns. Different event windows are analyzed in order to detect whether the investors anticipate the rating action and how quickly they react. The reactions in period before the financial crisis and during the crisis are compared. In next step the influence of other factors such as magnitude of rating change or rating being preceded by putting on the watchlist is analyzed by conducting the cross sectional regression analysis. The third part of the thesis provides the results of the analyses. No evidence of investors' respond to upgrades is found, which is consistent with previous studies. On the other hand the downgrades are informative to the investors and even more during the recent financial crisis. The negative announcement is not anticipated by the market. The market seems to overreact to the downgrades during the financial crisis. Actual rating changes invoke stronger reaction than watchlist listing. The analysis of companies with different market capitalizations show that the stock returns of small companies are more sensitive to the information published by rating agencies. Large companies react strongly to positive and negative rating changes during the financial crisis. The cross- sectional regression analysis examines abnormal announcement day performance of downgrades. The results show that only the magnitude of the downgrade is statistically significant and negative. Other factors such as number of other rating agencies monitoring the issuer remain not significant.

The study shows that despite the recent controversy around credit rating agencies, investors react to the announcements and rating changes. The time of financial crisis results in lack of credible and valuable sources of information. And credit rating agencies seem to remain informative in the eyes of the market.