University of Zurich

Department of Economics
Institute of Banking and Finance

University of Zurich UZH

How the effect of Credit Rating Announcements on Credit Default Swap Spreads changed - A Post-Crisis Event Study on the US Market

Master's thesis

Supervisor: Prof. Dr. Steven Ongena

Author: Feyyaz Aslan

Date of submission: 23.01.2017

Executive Summary

Objectives

This research framework provides an in-depth view into the effects of credit rating agency announcements on credit default swap (CDS) spreads for the time period following 2009. The first goal is to show whether the impacts of rating announcements on CDS spreads are still persistent, and if so, in which event windows these announcements influence the CDS spreads. Second, this study aims to compare the post-2009 results with a reference paper titled "Do Credit Rating Announcements Matter?" by Timo Brandstack, who found evidence for the observation period from 2000 to 2009. This systematic comparison reveals differences that emerged during the time of the financial crisis, and uncovers changes that the markets caused in the credit rating agencies' trustworthiness.

Data and Methodology

Credit rating data and CDS spread data range from January 5, 2009 to December 31, 2015. Reference entities given a long-term issuer rating of above investment grade by all the three major rating agencies (Standard & Poor's, Moody's, and Fitch) were taken from the whole S&P 500 Index; this resulted in a data set of 190 companies. Leaving out seven companies with no relevant rating changes during this time yields 183 companies, for which the five-year CDS contract – as this is the most liquid – is taken. The data set for these 183 companies and the five-year CDS contract consists of 322,263 spread observations.

Using the student's t-test methodology, the effect the rating announcements have on the CDS spread is subsequently analyzed for five different event windows, split up between [-60,60]. The results are then compared to the reference paper by Brandstack (2010), and the outcomes are separated by announcement type and illustrated in single tables.

Results

The results show a clear tendency of the credit rating announcements' weakening effects on CDS spreads. Whether for negative or positive rating announcements, the impact became much weaker and less significant for the time period following 2009. Moreover, the results provide evidence that markets are less likely to anticipate the rating announcements, and therefore react less prior to the announcement. For some announcement types, this leads to an immediate reaction once it is published; the strongest evidence in this regard is found for negative view watchlist announcements.

Still, one of the parallels to Brandstack (2010) is that negative announcements do have a stronger impact than positive ones. CDS spreads vary more intensely once a negative announcement is communicated as opposed to a positive one. Also comparable to Brandstack (2010) is the effect an announcement of down- or upgrading has depending on whether a watchlist announcement precedes the down- or upgrading. If there is no such watchlist announcement, the effect is stronger around the narrowest event windows, as the markets are less likely to have anticipated the announcement and therefore react quickly to the news. On the other hand, if there is a watchlist announcement, the down- or upgrading has its most significant impact beforehand – meaning in the [-60,-31] and [-30,-2] windows – as the move is anticipated due to this announcement.