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The information content of Australian credit ratings: A comparison between subscription and non-subscription-based credit rating agencies

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ABSTRACT

We classify credit rating agencies into two groups: subscribing and non-subscribing. Investors can access (non-subscribing) credit reports released to the public for no charge, or investors can subscribe to the fee-paying (subscribing) credit reports from agencies. Our results suggest that the information content of non-subscribing credit agencies is very low, whereas positive excess returns exist up to eight months after the announcement of credit upgrades from the subscription-only agencies. We support the hypothesis proposed in Grossman and Stiglitz [Grossman, S.J., Stiglitz, J.E., 1976. Information and competitive price systems. *The American Economic Review* 66, 246–253; Grossman, S.J., Stiglitz, J.E., 1980. On the impossibility of informationally efficient markets. *The American Economic Review* 70, 393–408]. Investors who spend resources on information acquisition should receive compensation for their information advantage, or there would be no incentive for such activity.

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1. Introduction

The aim of this paper is to analyse the short and long-run stock returns before and after the announcement of Australian credit rating changes. There are two alternative views on the information content of credit rating changes. One view is that credit rating agencies use publicly available

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information to analyse the financial fundamentals of rated firms. If the capital market is semi-strong form efficient, then there is no information in credit rating changes because share prices have already incorporated the information on which the change was based. An alternative view is that credit agencies have private information via their access to confidential information used in their debt market ratings. Private information releases might cause share price revisions. However, some credit rating agencies disseminate their credit reports in the form of press releases or via the electronic media, and act as low cost providers of additional information on the rated firms to the capital market. This study investigates whether the information content of credit rating changes of subscription-based credit rating agencies differs from that where the ratings are available free of charge.

The motivation for undertaking this research is to assess whether a credit rating change is a leading or lagging indicator of share market returns. If a credit rating change is a lagging indicator, the pre-announcement equity returns should be abnormally high (low) for credit upgrades (downgrades) and there will be normal equity returns after the announcement. If a credit rating change is a leading indicator, credit rating changes will make a significant impact on issuers' stock prices in the announcement period. For those firms that have been downgraded by credit rating agencies, negative abnormal returns should be expected on the announcement because it is difficult for downgraded firms to roll over their existing short-term debts. High borrowing costs will cause the operating and financial positions of the rated firms to deteriorate even though credit rating agencies advise rated firms on how to improve their financial fundamentals; they will take a long period of time to work through the negative effects of credit downgrades. For credit upgrades, normal or above normal equity returns are expected because low-rated firms will continue to improve their operating performances whereas high-rated firms will sustain their current performance to maintain their current credit ratings. Hence, an asymmetric pattern of stock returns between downgrades and upgrades is expected.

There are two types of credit rating agencies. The first category consists of credit rating agencies such as Moody's Investors Service and Standard & Poor's, which release their credit reports in the form of a press release or via the electronic media; these are classified as non-subscribing credit rating agencies. In contrast, subscribing credit rating agencies such as the Corporate Scorecard Group deliver their credit reports to fee-paying customers. This paper uses credit data from both sources to examine whether subscribers benefit from the products or services provided by subscribing credit rating agencies, using buy-and-hold abnormal returns (BHARs) after release of credit rating changes to subscribers.

Previous studies only focus on credit rating changes assigned by the non-subscribing credit rating agencies. For instance, [Pinches and Singleton \(1978\)](#) find abnormally high (low) stock returns before the announcement of credit upgrades (downgrades) and normal equity returns after credit rating revisions. They claim that the market has anticipated the information content of credit rating changes and has discounted the rated firms' stock prices. The results of this study provide support for their findings for the non-subscribing agency tests. In the period between September 1986 and June 2004, 104 observations of publicly listed Australian firms which are subjected to Moody's credit rating changes are investigated. The pre- and post-announcement BHARs based on the All Ordinaries Accumulation Index and industry and size matched control firm approach are calculated and there is no evidence of excess long-run equity returns after Moody's credit rating revisions. Therefore, both credit upgrades and credit downgrades are lagging indicators and investors cannot develop a profitable trading strategy based on the information content of publicly released credit rating changes. The results of this paper contrast with recent US studies which find abnormally low equity returns after the announcement of credit downgrades, whereas there is no evidence of abnormal equity returns for credit upgrades.

This paper suggests that investors can possibly use 'possible downgrade' credit ratings to predict future stock price movements. The 3-day post-announcement BHARs are negative and statistically significant at the 5% level based on the market index calculations whereas the 3-month, 6-month and 1-year post-announcement BHARs are negative and statistically significant at 5% based on the industry and size matched control firm approach. However, there is no evidence of excess positive returns after the announcement of possible upgrades. Additionally, the samples are divided into investment and speculative categories, the results indicate that most of the negative abnormal returns

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