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The impact of credit rating announcements on corporate CDS markets—Are intra-industry effects observable?



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ABSTRACT

This study examines the impact of S&P rating events on the credit default swap (CDS) spread of firms and the spillover effect on competitors for the period 2004–2011. We find that both credit downgrades and upgrades have an impact on the CDS spread of event and non-event firms on the event date. Downgrades are more anticipated than upgrades. Overall, the market reaction differs in extent and significance across industries and has been more pronounced since the beginning of the 2007 financial crisis.

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1. Introduction

Rating agencies play an important role in assessing the creditworthiness of corporate, subnational, sovereign, and supranational debtors. The agencies contribute to the reduction of asymmetric information among participants in financial markets. There is a vast literature examining the impact of rating events on financial markets. This literature has primarily focused on examining market reactions to rating announcements for firms listed on the stock market, bond market or, both (Dichev & Piotroski, 2001; Glascock, Davidson, & Henderson, 1987; Grier & Katz, 1976; Hand, Holthausen, & Leftwich, 1992; Hite & Warga, 1997; Holthausen & Leftwich, 1986; Katz, 1974; Pinches & Singleton, 1978; Purda, 2007; Steiner & Heinke, 2001; Vassalou & Xing, 2003; Wansley, Glascock, & Clauretje, 1992; Weinstein, 1977). Seminal papers by Norden and Weber (2004) and Hull, Predescu, and White (2004) and subsequent studies by Micu et al. (2006), Imbierowicz and Wahrenburg (2009), and Galil and Soffer (2011) extended the literature by investigating the effect of market reactions to rating events on credit default swap (CDS) markets. Similar to previous studies, these revealed decreasing CDS spreads around credit upgrades and increasing CDS spreads for credit downgrades. A common feature of all these studies is that they explored the direct impact of rating events on firms that were downgraded or upgraded. Following Lang and Stulz (1992), we argue that the market reaction for event firms does not reveal how much of the information in the rating announcement is firm-specific and how much is industry-wide. Furthermore, the rating event does not reveal whether and to what extent competitors profit or suffer from credit downgrades or upgrades. The impact of rating events across industries and the spillover effects on competitors have not yet been studied.

This paper extends the literature in several ways. To the best of our knowledge, this is the first study to analyze the impact of rating events on event firms for both a global portfolio and for industry portfolios separately, using daily CDS spreads from 2004 to 2011. Second, we compute the spillover effect of rating events on the CDS spreads for competitor firms around the event date. Third, cross-sectional regression is applied to analyze the factors that determine the market reaction of competitors. Similar to related studies (Galil & Soffer, 2011; Hull et al., 2004; Norden & Weber, 2004), we compute rating-adjusted cumulative abnormal CDS spread changes (CAS) when measuring the impact of credit rating events on event firms and their competitors.

Our findings suggest that significant asymmetric market reactions exist around credit downgrades and upgrades for event firms. The results indicate positive CAS around downgrades and negative CAS around upgrades. Since the results are not homogeneous across industries, we provide evidence that the results for the overall sample should not be generalized across industries, but should be examined separately. Furthermore, the findings suggest spillover effects on competitors. We document negative CAS for competitors around downgrades and positive CAS for competitors around upgrades. The cross-sectional regression analysis reveals that the level of rating changes, the comprehensive credit rating of competitors, and the financial leverage determine the CAS. The market reaction has even been more pronounced since the beginning of the financial crisis.

Our findings may be useful for investors and regulators when constructing portfolios sensitive to credit risk. Owing to the increased use of financial instruments related to credit risk, such as CDS, the findings may also be helpful for regulators when implementing new capital adequacy frameworks for individual industries such as the financial sector.

The remainder of the paper is organized as follows. Section 2 describes the measurement of credit risk. In Section 3 we develop our hypotheses. The data used for the analysis are described in Section 4. In Section 5 we present the method used to test for the impact of rating events on market prices. Section 6 details empirical results for the analysis of spillover effects on competitors. Section 7 concludes the paper.

2. Measuring credit risk

The pricing of credit risk has become an important topic for participants in financial markets, especially after defaults by a number of well-known firms around 2001 (Enron, K-Mart, Polaroid, Swissair, etc.). In this context the CDS market offers tools for hedging or pricing credit risks. A CDS is a contract in which the protection buyer makes a series of premium payments in exchange for the right

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