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The (un)informative value of credit rating announcements in small markets[☆]

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ABSTRACT

This work examines the information value of local Israeli credit rating announcements. This matter is also important to other small markets, in which a debt issuer may take advantage of a “rating shopping” process or choose to avoid a rating procedure altogether, because the agencies do not carry out unsolicited rating. We analyze the bond and equity markets response to various rating announcements at different time periods. We find that except for downgrades in 2008–2009 the rating announcements have no information value. It seems that generally the market internalizes most of the information prior to the rating announcements.

1. Introduction

Rating agencies are a major source of financial information and their influence in the developed markets has increased in recent decades and has spread into smaller economies such as the Israeli bond market. Kräussl (2005) showed that negative announcements regarding sovereign ratings of emerging countries has a significant effect on the financial stability of such economies. A report by the Basel Committee on Banking Supervision (2000) estimated over 130 rating agencies worldwide and White (2002) mentioned over 30 rating agencies in developing countries, mostly national in their focus.[1] Langohr and Langohr (2010) estimated the number of rating agencies worldwide at 150. The main role of these agencies is mitigation of the information asymmetry problem that exists in debt markets and emergence of local rating agencies is associated with an attempt to develop a local public debt market. The Basel committee reported that rating agencies may operate under diverse conditions (e.g. with respect to the level of regulatory reliance on credit ratings) choose different rating policies (solicited vs. unsolicited ratings) or apply different revenue models (issuer-pay model vs. investor-pay model). This work aims to research the local rating agencies information value in the Israeli market. We believe this matter is important to small markets, where similar to Israel, unlike the U.S. and other developed large markets, a debt issuer may take advantage of a “rating shopping” process or may choose to avoid a rating process because the agencies do not initialize unsolicited rating.

The informative value of ratings has been repeatedly challenged. The rating agencies follow thorough rating evaluation processes, employing stringent criteria, and thus often seem to slowly react to new developments, leading to allegations that ratings do not provide new information to the financial market. In response, rating agencies have argued that their criteria not only aim for appropriate timing but also for stability (Löffler, 2005), so that ratings are only changed when a reversal of the change is unlikely. Although Altman and Rjken (2004) empirically showed how rating agencies attempt to manage the tension between timeliness and stability, the issue of the information content of ratings remains an

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[1] The developing countries with local rating agencies include: Argentina, Bangladesh, Brazil, Chile, China, Columbia, Cyprus, Egypt, India, Indonesia, Israel, Korea, Malaysia, Pakistan, Peru, Russia, South Africa, Taiwan, Tunisia, and Venezuela.

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open issue because ratings are required to be instrumental even when their updates are delayed. In their dual goals of timeliness and stability, rating agencies are also supposed to possess and use information which is not publically available in the markets.

The skepticism regarding the information relevance of credit ratings has yielded numerous studies that have tested the market response to announcements by rating agencies. The early studies in the 1970s used bond and stock prices (e.g. Katz, 1974; Grier and Katz, 1976; Weinstein, 1977). More recent studies using Credit Default Swap (CDS) data, such as those by Hull et al. (2004), Norden and Weber (2004), and Galil and Soffer (2011), indicate that this research question is of an ongoing interest. The large number of studies on this topic also indicates the difficulty in reaching conclusive results.

Generally, research found that various U.S. markets predominantly respond to negative reviews rather than to downgrade announcements. In contrast, other global market studies, including the U.K. (Barron et al., 1997), Australia (Matolcsy and Lianto, 1995), Japan (Li et al., 2006), and China (Poon and Chan, 2008), found that these non-U.S. markets react to negative announcements (downgrades and negative reviews) but not to positive announcements (upgrades and positive reviews). Elayan et al. (2003), analyzing the New-Zealand rating, found also significant market response to positive announcements and suggested that this special behavior of the New-Zealand capital market arises from its relatively small size. However, Abad-Romero and Robles-Fernandez (2006) analyzing the rather small Spanish corporate bond market concluded in unusual results: absence of response to downgrades and negative response to upgrades.

Overall, the above studies demonstrate that the rating activity information value depends on the specific properties of the local capital market and its rating industry. Rating agencies compete with other sources of information and therefore their added value depends on the other information channels' significance in that market. The Israeli capital market and rating industry offer an interesting arena for the examination of rating agencies' effectiveness in a young, small, and expanding corporate-bond market. While in the U.S. ratings are not obligatory by law, they are de-facto mandatory by market customs and some financial institution demands. In order to invest in investment-graded bonds, bonds have to be rated. The majority of bonds issued by large issuers are even rated by two leading agencies (see e.g. Bongaerts et al., 2012). The policy of unsolicited ratings by S&P and Moody's (when rated firms do not ask to be rated) also incentivizes issuers to seek rating. This need heightens as the rating agencies panelize issues with unsolicited rating by assigning lower ratings to them (see Bannier et al., 2010).

In contrast, the Israeli corporate bond market is relatively young, it has been insignificant until 2001.[2] The local rating agencies services are less used in Israel and unrated debt is much more common compared to matured markets. Furthermore, as the Israeli rating agencies do not initiate unsolicited ratings, de facto, it is a discretionary choice of each bond issuer whether and from whom to purchase a rating, hence allowing "rating shopping" opportunities and rating catering (see Bakalyar and Galil, 2014). Moreover, this market is also characterized by a dominant banking system, it is highly centralized, and highly influenced by control pyramids (of a dozen tycoons). The corporate bond market is relatively young, and in addition to the home biased investment sentiment, the culture is of a small market ("everybody knows everybody else"). Thus, the relative advantage of rating agencies, stemming from their access to private and internal client information, might diminish. It is possible that the same information (or parts of it) is accessible to the institutional investors which dominate the Israeli bond market. The lax-screening on the local corporate bond market was also held responsible for the financial crisis in Israel in 2008 and the many 'hair-cuts' that followed. These market characteristics and the lack of prior studies are the raisons d'être of this research and form the basis for its contribution to the research literature.

This paper evaluates the information value of Israeli credit rating agencies announcements. We analyze the equity and bond markets response to various rating announcements at different time periods relative to the announcement day. The database of this study includes 961 rating announcements for the period 1 January 2000 to 31 December 2009, of the two Israeli rating agencies – S&P Maalot and Midroog, which are affiliated with the international firms S&P and Moody's respectively. Due to certain voids in trading information we use 681 and 566 announcements for the equity and bond market respectively. We generally follow the methodology usually used in similar studies with slight adaptations for the Israeli market. We mainly use event study methods measuring abnormal returns. To control for other information sources we use the common filtering process and we also employ the relative new approach of Galil and Soffer (2011). We assess the statistical significance of our results using the parametric *t*-test and non-parametric sign-test, drawing conclusions and presenting both test outcomes.

We assess the market reaction to rating agency announcements by measuring abnormal returns in the bond market and the equity market and identifying periods of unexpected patterns. For example, abnormally low returns, prior to a negative announcement, suggests that the market already anticipates and internalizes the negative information prior to the announcement date. Statistically significant negative abnormal returns immediately after such announcement support the hypothesis that the rating announcement delivers informational value to the market. An exceptionally positive reaction shortly after a downgrade might be related to a market correction after a behavioral over-reaction, shading doubts on the informational value of the announcement.

We expect market response to rating announcements mainly in the bond market because ratings relate to the riskiness of debt (not necessarily of stocks). However, there are two concerns affecting such analysis. First, bond markets tend to be shallow and thus illiquidity might hide economic bond value changes irrespective of the announcement uninformative nature. Second, investment managers might react to rating downgrades because of regulatory restrictions on the quality of bonds in their portfolios. If so, bond prices response to rating announcements may reflect "portfolio composition rules" even when rating announcements are not informative.[3] Analysis of the stock market response is not affected by these two concerns. First, the stocks market is much more liquid than the bonds market despite the fact that both take place on the same exchange platform. Second, stock-portfolio managers do not face rating related restrictions and therefore automatic response is not expected in the stock market. Nevertheless, the analysis of stock market response has its pitfall. Goh and Ederington (1993) find evidence for wealth substitution effect in leverage related rating announcements: downgrades due to increasing leverage affect

[2] To complete the exposition we present a short history of the Israeli bond market in Section 2.1, especially for readers unfamiliar with this market.

[3] Institutional investors holdings of financial assets adhere to two types of restrictions. One is a set of regulations enacted by the government such as the "Joint Investment Trust (Assets that may be Bought and Held by a Fund and their Maximum Amounts) Regulations, 5755–1994," signed by Avraham (Beige) Shohat in 1994, then the Minister of Finance, after formal approval in the Knesset (the Israeli parliament). The other binding set of investment rules is specified in the fund prospectus which defines, for each fund, additional investment restrictions that must be followed. These two types of restrictions may cause trading forced by rating agencies' announcements.