



## The economic function of credit rating agencies – What does the watchlist tell us? ☆

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### ABSTRACT

Credit rating agencies do not only disclose simple ratings but announce watchlists (rating reviews) and outlooks as well. This paper analyzes the economic function underlying the review procedure. Using Moody's rating data between 1982 and 2004, we find that for borrowers of high creditworthiness, rating agencies employ watchlists primarily in order to improve the delivery of information. For low-quality borrowers, in contrast, the review procedure seems to have developed into an implicit contract à la Boot et al. (2006), inducing the companies "on watch" to abstain from risk-augmenting actions. The agencies' economic role hence appears to have been enhanced from a pure information certification towards an active monitoring function.

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### 1. Introduction

Credit rating agencies such as Standard and Poor's (S&P), Moody's Investors Service (Moody's), or Fitch, Inc., provide qualitative statements on the creditworthiness of entities and their financial obligations. Use of credit ratings has expanded in recent years, mostly due to the globalization of financial markets, the growing complexity of financial products, and, generally, an increasing usage of ratings in financial regulation and contracting (Frost, 2007).

The widespread use of credit ratings has been accompanied by a rise in the complexity of the rating information. Most credit rating agencies not only offer a rating for a company issuing securities and for the individual financial products issued, but supplement

their service by providing additional information via rating outlooks and rating reviews ("watchlists")<sup>1</sup> that give indications of future credit rating changes. While rating outlooks represent agencies' opinions on the development of a credit rating over the medium term,<sup>2</sup> rating watchlists are stronger statements, as they focus on a much shorter time horizon – three months, on average (Keenan et al., 1998).<sup>3</sup>

Review listings are usually triggered either by discrete corporate events such as, e.g., the announcement of a merger or a share buy-back, or by trends in a corporation's operations or financial conditions. A rating may be put on review for possible downgrade or upgrade or with direction uncertain. During the watchlist interval, the rating agency collects additional information on the firms it rates, which typically leads to an interaction between rating analysts and firm management. The watchlist is eventually resolved by the announcement of either a rating change or confirmation of the initial rating. The proportion of ratings "on watch" has sharply risen in recent years: until 1998 about 10% of bond issuers, on

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<sup>1</sup> Moody's reports ratings currently as being under review on their "Watchlist"; S&P refers to its "CreditWatch." In the following, we use the notions of rating watchlists and rating reviews interchangeably.

<sup>2</sup> Rating outlooks are generally terminated after 12–18 months.

<sup>3</sup> In the study by Keenan et al. (1998), the 10 (90)% quantile is 22 (95) days for firms that are placed on watchlist with designation downgrade. For firms entering the watchlist with designation upgrade, the mean is 115 days, with 21 (218) as the 10 (90)% quantile.

average, were under review at Moody's; between 2000 and 2004, this percentage increased to about 40% (Hamilton and Cantor, 2004; Chung et al., 2008). Obviously, rating watchlists have grown into heavily used instruments to transmit information to financial markets.

Moody's, as one of the oldest rating agencies, has been publishing a list of ratings on review since 1985.<sup>4</sup> However, it only started to consider watchlist assignments as formal rating action on October 1, 1991. Since that time, Moody's employs a full rating committee to decide whether to place a borrower under review and how to resolve the watchlist. Interestingly, Moody's states: "That rating changes for issuers placed on the watchlist are different from issuers not on the watchlist, implies that the watchlist is an important source of information for market participants interested in measuring credit risk." (Keenan et al., 1998). In this paper we use Moody's rating data to try to answer two questions with respect to this statement. First, is it true that there is a difference between watch-preceded rating action and direct, i.e., not-review-preceded, rating action? Second, if so, how can we explain this difference? Based on our results, we then argue whether the review process has enhanced the rating agencies' traditional role as information providers.

Our paper contributes to the growing literature on information provision by credit rating agencies. With seminal studies in the late 1980s and early 1990s (Holthausen and Leftwich, 1986; Hand et al., 1992), there is now an established set of empirical results with respect to the informational content of rating changes. Most of the studies find that the rated firms' equity reacts negatively to downgrades, but rarely observe a significant reaction to positive rating changes (Cantor, 2004; Behr and Gnttler, 2008).<sup>5</sup> While bond prices tend to react asymmetrically as well, the effect is not quite as strong (Wansley and Clauretje, 1985).

Few studies have yet examined the informational content of the watchlist instrument. Holthausen and Leftwich (1986) use S&P's Credit Watch data in the period 1981–1983 and find tentative evidence that watch-preceded rating downgrades provide less information than rating changes not preceded by a formal review process. However, their small sample size hampers reliable inferences. Hill and Faff (2007), in contrast, conclude from sovereign ratings that the market does not react any differently to the two types of rating changes. They observe that prior to a watch-preceded downgrade, the market seems to anticipate the event by displaying negative returns but has a significantly positive reaction after the downgrade.<sup>6</sup> Norden and Weber (2004) report similar anticipation effects of corporate rating reviews both on stock and credit default swap (CDS) markets. Purda (2007) distinguishes between expected and unexpected rating changes, where rating reviews are one among several ingredients affecting rating change expectations.<sup>7</sup> She concludes that there are no differences in market reaction to anticipated versus surprise rating changes. Chung et al. (2008) are the first to give an extensive overview on the characteristics and information value of credit watches. They observe that

watch-preceded rating changes are more often triggered by corporate events than are direct rating actions and that the watchlist instrument helps rating agencies to supply information to financial markets. Our paper contributes to these earlier studies in at least two ways: first, we investigate explicitly the economic function underlying the review procedure. Essentially, we test between two different explanations for this particular rating instrument. Second, and in contrast to earlier work, we draw inferences not only from market reaction studies but use several approaches to discriminate between the two lines of argument. This allows us to take a more robust view on the role of credit rating agencies in financial markets.

As a first pre-study, we employ Moody's estimated senior unsecured ratings between 1982 and 2004 to test for a time series break in the market reaction to rating changes due to the institutional implementation of the watchlist on October 1, 1991. The market reaction is measured by the rated companies' cumulative abnormal stock returns. In line with earlier work, we find a significant reaction following negative rating changes only, but not following upgrades.<sup>8</sup> Comparing the pre-watchlist period (April 26, 1982–September 1991) with the post-watchlist period (October 1991–December 2004), we see that the informational content of downgrades significantly increased after the watchlist introduction. This result is robust to business cycle effects, regulatory changes and sample composition effects and, consequently, underlines the conjecture implicit in the initial Moody's statement that the watchlist instrument has in some sense influenced rating agencies' traditional role as information providers.

In our main analysis, we test between two different explanatory lines for the review procedure: first, the creation of an additional rating process via the watchlist may be a simple means to comply with investors' demand for accurate and timely, but also stable rating information (Cantor and Mann, 2006). According to this argument, a watchlist may be invoked whenever investors' needs for information are particularly strong (Chung et al., 2008), so that the watchlist helps to improve the information-certification role of credit ratings. As an alternative, however, it has recently been argued that credit ratings may also be used as an instrument to coordinate investors' anticipation of credit risk (Carlson and Hale, 2006). As a consequence, an intensive monitoring process via the watchlist should allow rating agencies to influence firms' risk choices by threatening them with imminent rating downgrades and subsequent investor reactions. In a theoretical model, Boot et al. (2006) have shown that this "implicit contract" feature enables watch-preceded credit ratings to convey information of a different quality: Whereas a direct downgrade signals a firm's lack of capability to uphold a specific credit quality, a watch-preceded downgrade signals a failure in the attempt. According to this argument, the watchlist gives rise to an active monitoring role of rating agencies.

Since both explanatory approaches are particularly convincing for the case of negative developments in credit quality, our analyses focus on imminent rating downgrades. The two arguments ("delivering information" versus "implicit-contracting") allow the derivation of distinct predictions both with respect to the watchlist placement of firms, the length of the review procedure and the market reaction to direct vs. watch-preceded rating changes. Interestingly, our empirical analyses indicate that we have to differentiate between high-quality borrowers and low-quality borrowers. For the former, we find that the watchlist procedure is mainly used to deliver precise and stable information in order to feed investors' demand. Particularly the decision to list a firm on review depends strongly on investors' quest for information. The market reaction to

<sup>4</sup> Standard and Poor's instituted a watchlist in November 1981.

<sup>5</sup> There are exceptions to this generally accepted asymmetry in market reaction: First, Jorion et al. (2005) find a significant positive abnormal return following upgrades after the introduction of the Regulation Fair Disclosure on October 23, 2000, by the SEC. Second, Goh and Ederington (1993) observe a significant negative abnormal return only for downgrades associated with a deterioration of the firm's expected financial performance but not for those attributed to a reorganization or an increase in financial leverage. Regarding cross-sectional aspects, stronger market effects are generally obtained for downgrades to and within the sub-investment-grade rating category (Goh and Ederington, 1999).

<sup>6</sup> This result is supported by Hull et al. (2004), who focus on ratings' effects on credit default swaps and find that while additions to the watchlist (with designation downgrade) are informative, the eventual rating downgrades are not.

<sup>7</sup> Hill et al. (2010) show that rating outlooks are even better predictors of sovereign rating changes than watch listings. Livingston et al. (2008) report that also rating splits contain important information regarding future corporate rating changes.

<sup>8</sup> We also do not observe a significant market reaction to ratings that were confirmed after having been placed on review.

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