

What it means to be downgraded in Europe

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This study adds to the body of literature by proposing theoretical framework and providing empirical evidence on the stock market perception of a bond rating downgrade for European non-financial companies. The contributions of this study are in threefold. Firstly, complementing the current literature, this study provides a different perspective of looking at the presence of bond rating downgrades from the viewpoint of the downgraded companies instead of from that of the investors. Secondly, this study explores the impact of a downgrade during various types of business cycle in Europe, which involves the era of Euro introduction until the most recent era of worldwide financial market collapses. Thirdly, supporting the upcoming importance of Eurobond in the world's investment market, this study attempts to provide empirical evidence on the risk assessment practices for non-financial bond issuers in the European community.

I. INTRODUCTION

Bond Rating is defined as the objective opinion of a rating agency about the credit quality of a debt issuer, based on various types of information such as the debt issuer's relative default probability, loss severity, financial strength, and transition risk¹. Rating agencies proclaim that their ratings are fair, reliable and independent. The ratings are *fair* because they consist of information from the rated companies' own opinion and insight², which enables rating agencies to set the most appropriate context for evaluating the company's credibility to meet its debt obligation in the future. The rating agencies then combine insider information with their own analysis of the company's financial information to produce a *reliable* opinion. From the Efficient Market Hypothesis perspective, if a rating is reliable, it should add to the efficiency of information flow in the capital market by providing (new) information that can be used to bridge the informational gap between management and investors. The informational gap exists because management knows better about the 'true' worth of the company. Ratings are expected to give a warning about the 'true' creditworthiness of the company, which should be early enough so that the informational gap can be reduced significantly without making it possible for any parties to take advantage of or losing opportunities from the situation. However, there were many cases (during the Asian, Latin American, and Russian Crises, and the most current company-specific

¹ Transition risk refers to a company's default probability with respect to the levels and timing of credit events. It is this specific feature that differentiates the degree of credit risk of financial institutions and other types of institutions. This is because financial institutions depend heavily on external sources to support their businesses, which makes them confidence-sensitive issuers hence more prone to the changes of their creditworthiness (bond ratings) than other types of industry.

² The private information is naturally clientele subjective and contains information about the company's strategic arrangements such as the assessment of competitors, market forecasts, budgeting program, financing alternatives or re-capitalisation plans.

cases such as the Kmart, Enron, Worldcom, and Parmalat failures) whereby ratings have failed³ to effectively reduce the informational gap in the market. Therefore, the existence of ratings and rating agencies becomes questionable. In addition to being fair and reliable, rating agencies are also expected to be *independent* in their opinions about the rated companies. According to the Agency Theory, however, the independence of rating agencies may be questionable because rating agencies receive their main income from the rated companies implying a kind of hidden obligation⁴ to assign a good rating for their clients. Economically, this is possible, but logically, if rating agencies did (consistently) deliver a biased opinion towards the rated companies, their risk assessment would have contained a persistent record of mis-rating. The fact is that the role of rating agencies has become even more important in recent period. Berger, Davies, and Flannery (1998) find that not only can ratings be used to help regulators in their supervisory assessment, ratings are also found to be more accurate than the regulators' assessments in predicting bank performance. Blume, Lim, and MacKinlay (1998) suggest that the significantly excessive numbers of downgrades from upgrades between the period of 1978-83, 1984-89, and 1990-95 are due to the more stringent standards that are imposed by rating agencies in an attempt to keep up their performance.

An upgrade or a confirmation of the current rating is always considered good news because it does not have a negative impact on the firms' risk profile. However, a downgrade has been associated with bad news because it means that the rating agencies have deemed the company to be riskier. In other words, after a downgrade, a company may be considered to have (a) lower

³ The failure is usually estimated from the timing of the rating change announcement to the timing of when company revealed its 'true' creditworthiness, such as when the company announced that it has filed for Chapter 11 Bankruptcy or Chapter 7 Re-capitalisation.

⁴ The connotation of 'hidden obligation' refers to a bad credibility being marked up as a good one.

credibility; (b) higher probability of default; (c) too risky financial projects; (d) too much debts; and (e) lower growth of profitability. The list of why a downgrade is perceived to be negative is not exhaustive, but its presence has been found to negatively influence the company's cost of capital and market value.

The contributions of this study are in threefold. Firstly, this study will fill the gap in the current literature by looking at the presence of bond rating downgrades from the viewpoint of the downgraded companies instead of from that of the investors. Secondly, this study will explore the impact of a downgrade during various types of business cycle in Europe, which involves the era of Euro introduction until the most recent era of financial collapses in emerging stock markets such as those in Asia, Russia, and Latin America. Thirdly, supporting the upcoming importance of Eurobond in the world's investment market, this study attempts to provide empirical evidence on the risk assessment practices for non-financial bond issuers in the European community.

More specifically, this study will answer the following questions. Firstly, is the presence of rating agencies in the European market influential? We attempt to answer this question by investigating the stock market reaction to announcements of bond rating downgrade made by the rating agencies. Secondly, do the European market participants react to the announcements of the downgrade or to the financial events that underlie its revelation? We will examine the reasons for the downward revision to answer the second question. Thirdly, will a bond rating downgrade force the companies' managers to become more risk averse in the future? We should be able to find answers to this question by conducting an archival analysis on the companies' management

compensation and realized plans. Fourthly, is the systematic risk of the downgraded companies also changed after the companies' fundamental risk is changed? We will answer this question through time series analysis of the companies' beta surrounding the announcement of the bond rating downgrades. Finally, we also question if there is any change in the worst possible earnings or cash flows that a company may have to survive with after it is downgraded. We will calculate the company's Earnings-at-Risk (EaR) and Cash-Flows-at-Risk (CFaR) to answer the last question.

The rest of the paper is organised as follows. The second section will discuss the theoretical background of our hypotheses, which will be followed by the data and methodology that we use to test our hypotheses. Section four provides a review and interpretation of our findings; and the last section will conclude our study.

The final draft of this paper will be ready for a submission on November 17, 2004.