Chapter 1

Introduction

1.1 Introduction

The largely publicised bankruptcy case of Lehman Brothers and Bear Stearns in year 2008 in the wake of the United States of America's sub-prime mortgage crisis had again put the independent credit rating agencies in the same limelight as it had before during the collapse of Enron, a US energy corporation back in year 2000. In the case of Lehman Brothers, the company was assigned with investment grade ratings by the three major credit rating agencies (Standard and Poor's, Moody's and Fitch) until the day of default. Enron, on the other hand was granted investment grade ratings by the same rating agencies until four days prior to when the actual situation came to light (Duff and Einig, 2009).

This coupled with the recent developments in credit rating models[1] has prompted questions from regulators, investors and the research community alike: do rating announcements made by credit rating agencies disseminate valuable informational content to the capital market? In other words, are rating changes a signal for new information to the investing public? How timely is the

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[1] Credit rating models are conventionally made up of two types i.e. the linear regression and ordered probit models; current developments sees applications of weighted average models; see Metz (2006).

information disseminated through these bond rating announcements and how valuable is the information?

According to Fama (1970), an efficient market will reflect all information whether publicly available or not; hence the inability of investors to gain abnormal returns. Prior research done on this area has been largely inconclusive in large foreign markets such as the United States of America (Hand, Holthausen and Leftwich, 1992; Zaima and McCarthy, 1988; May, 2010) or in smaller as well as developing markets such as Australia (Matolcsy and Lianto, 1995), Spain (Abad-Romero and Robles-Fernández, 2006) even China (Poon and Chan, 2008).

The Malaysian bond market is the largest as compared to other ASEAN bond markets[2]. Studies on informational efficiency in the Malaysian context however also yielded different results (Chelliah, 2002; Raman, 2002; Doma and Omar, 2006). Such results may be due to the different parameters being set and studied in the researches. This paper attempts to research on the current Malaysian scenario through the Malaysian bond market.

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[2] See http://asianbondsonline.adb.org/regional/data for comparison of size of local and foreign currency bond market size among ASEAN countries.

1.2   Purpose and Significance of the Study

The main objective of this research is to study the informational efficiency of the Malaysian financial markets. More specifically, we are investigating whether corporate bond ratings announcements signal the arrival of new information to the market as perceived by the investing public.

Firstly, we investigate whether rating announcements made by credit rating agencies are perceived to contain informational value in the Malaysian context. The adequacy of data from the bond market required for analysis however is in question in view of the relative illiquidity of the Malaysian bond market as compared to the stock market. Coupled with the fact that only a small number of bonds are traded on the Malaysian stock market[3], the information on bond yields available to the public may not be uniform. In view of all these issues, we attempt to study the informational value brought upon by rating announcements towards stock returns.

Secondly, we try to address some of the issues pertaining investor behavioural conduct according to the levels of credit rating change announced. Our model aims to study the effects of rating changes as differentiated in terms of magnitude of change (small or big) towards market movements.

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[3] As of the 3rd quarter of year 2010, there are currently around 32 loan stocks from 24 issuers trading in Bursa Malaysia (The Star, 26th September 2010).

The empirical findings from this study are significant. The Malaysian bond market is evolving, having undergone massive development throughout the years with the initiatives taken by the government[4]. The timeline employed, that is from January 2000 to December 2009, allows a more current perspective on the perception of effects and timeliness of information dissemination through bond rating announcements to the Malaysian securities market.

Earlier studies in both foreign and local financial markets had found that the magnitude of change in terms of stock prices triggered by the change in bond ratings is amplified during the occurrence of a major economic event as compared to non-major economic event periods (Joo and Pruitt, 2006) or caused unanticipated market reactions (Doma and Omar, 2006). Another significant point of this research is that the study timeline is refined to exclude identified major economic event such as the Asian Financial Crisis.

Such findings are expected to benefit prospective investors in forming their investment portfolio and making future investment decisions. Portfolio managers and brokers-dealers too may find this study useful in designing their trading strategies and to profit from these anticipated differences.

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[4] http://www.bondinfo.bnm.gov.my/ assessed on 22nd October 2010

1.3 Research Questions/ Objectives of the Study

Three research questions are developed for this study:-

a) Do corporate bond rating upgrade and/ or downgrade announcements impact the firm's stock returns?

b) How does the result differ between big and small upgrades and/ or downgrades?

c) If rating announcements do impact stock returns, how long does it take to be reflected in the stock returns?

1.4 Scope of the Study

This study focuses on corporate bond rating changes on long-term (exceeding 12 months) debt instruments for companies listed on Bursa Malaysia (formerly Kuala Lumpur Stock Exchange or KLSE). All other forms of debt instruments such as short term debts and Islamic debt instruments are excluded from the scope of this study. The event selected in study is bond rating change announcements (both upgrades and downgrades). Events pertaining placements of debt instruments under credit watchlists are excluded. To ensure uniformity of rating criteria and process, this paper focuses on rating change announcements made by Rating Agency Malaysia

Berhad (RAM) which is also the nation's longest-serving local independent rating agency with more than 3,200 ratings assigned[5].

This study has attempted to steer away from the Asian Financial Crisis which occurred between years 1997 and 1998 whereby a majority of bonds are found to be assigned rating downgrades or even defaults so as to create a more objective environment as the basis of this research. Thus the study timeline of this research runs between the period of 1st January 2000 and 31st December 2009.

It is found that the announcement dates of a rating change may differ according to the type of media selected for study. The discrepancy found may be due to the different dates of which a rating is published in a broadcasting media such as between different newspapers. A check on the data samplings indicate that the rating announcements published by Bloomberg are slightly earlier as compared to that of a newspaper. In the context of this study, announcement dates as published in the Bloomberg database are utilised in lieu of the other various forms of media. It is worthy to note that the variance between these dates generally ranges only between one or two days.

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[5] http://www.ram.com.my assessed on 22nd October 2010. As it is mandatory for Malaysian domestic debt issuers to obtain the rating for issuance since May 1992 (see http://bondinfo.bnm.gov.my), all local issuances are rated by either RAM or MARC. Some debt issuers also obtain ratings by international rating agencies such as S&P and Moody's.

1.5   Organisation of the Study

This thesis is mainly divided into six chapters:-

Chapter 1 – Introduction

The chapter serves to underline the purpose and significance of this research whereby the research objective, scope and limitations are all spelled out.

Chapter 2 – Background

The chapter describes the Malaysian bond market with elaborations on the corporate segment of the market, credit rating agencies and the general workings of a bond rating process.

Chapter 3 – Literature Review

This chapter opens with the Efficient Market Hypothesis (EMH) and the informational efficiency of the financial market and cover various literatures of past researches pertaining salient issues on the content of bond rating announcements and its relationship with bond and/ or stock returns. A separate section is dedicated to prior research along this area of interest in the Malaysian context.

Chapter 4 – Data and methodology

This chapter describes the hypotheses drawn to be tested in this study. The selection of measures, sampling design, data collection and data analysis methodologies used in this study are all detailed in separate sections.

Chapter 5 – Findings

This chapter mainly reports on the empirical findings based on the analysis methodologies described in Chapter 4.

Chapter 6 – Discussion and conclusion

This chapter provides a section for the summary and conclusion of the paper. Limitations and recommendations for future research areas are also elaborated there.