CHAPTER 1 : INTRODUCTION

1.1 Purpose and Significance of Study

One of the most common and simplest definitions for a rating is that it is an objective and unbiased opinion of a rating agency. Ratings is the barometer used by the various members of the investing public to assess the credit worthiness of a business organisation.

The scope of this study is to:

- establish whether the investing public gain any new information from the announcement
  of ratings
- establish the impact, if any, of rating exercises, including initial assignments, reaffirmations, downgrades and upgrades. Differences in impact, if any, among these rating exercises are also analysed.

This study will analyse the impact of share prices of companies that is affected by credit rating announcements done by the Rating Agency of Malaysia (RAM). It will try to establish whether the investing public gains any new information from the announcements of ratings.

According to the efficient market hypothesis, an efficient market is able to swiftly disseminate information so as to ensure that the asset prices constantly reflect the most up-to date market information.

However, market efficiency is not uniform. There are various levels and types of efficient markets. Past research has proven that there are at least three forms of efficient markets. The hypothesis is that there are weak, semi-strong and strong forms of efficient markets (Bodie, Kane and Marcus, 1999). Chapter on literature review will discuss further about the market efficiencies.

This study will concentrate on the semi-strong market efficiency hypothesis to identify the impact of ratings announcements of stock prices.

Although much research has been done on the semi-strong form of market efficiency in the equity market especially in the United States and to some extent in Europe, very little conclusive parameters have been established. Presently there are two dominant schools of thought on the effect of ratings announcements on a stock price within a semi-strong form of market efficiency environment.

According to Wakeman (1990), rating agencies do not generate any new information apart from making use of what is already publicly available in the marketplace. As such, announcements made by rating agencies merely highlight information that is already available. In efficient markets such pronouncements are unlikely to have major impact on the stock prices as the market players would have already either factored in or discounted the information. This is especially so as in some cases there could be significant time lag between the release of information and the time taken to publish the interpretation of the information in the form of ratings. This being the case, the rating announcement will not induce any wealth effect on stockholders. The fact that generally most rating agencies only make rating announcements on a fixed periodic basis further compounds the time lag between information availability at the marketplace and information dissemination among stockholders.

The second school of thought dictates that rating agencies have access to other sources of information besides those which is available at the marketplace. These information can be from various sources including primary information generated through internally.. Information can be gathered via various means including onsite visits to company premises, meetings with top management, analysis of current and forecast results of profit and loss statements and balance sheet data. In short, the strength of rating agencies lies not only in their ability to generate reports on rating announcements based on publicly available information but also incorporating additional information not freely available to the investor community at large. This being the case, the rating announcements released

will have a material impact on shareholder's perception of share prices because the investor community at large are cognisant of the added information incorporated within the rating announcement. In these cases, rating announcements can substantially impact the share prices of companies in question.

As such, this study will first determine whether RAM, the designated rating agency for this study, provides 'extra' information that is not freely available to the investing community. This can be determined by analysing the material effect that RAM's rating announcements have on share prices. If such announcements can give rise to abnormal returns, it can be inferred that RAM's announcements does provide supplementary information not available to other market players. If the announcement only gives rise to normal returns, then the assumption is that the announcements do not provide any new information. This study will establish the impact, if any, of rating exercises, including reaffirmation, downgrades, upgrades and ratings watch. Differences in impact, if any, among these different rating exercises are also analysed.

Generally rating agencies announce initial ratings, which are then reviewed periodically or on an ad-hoc basis. The reviews will dictate whether the initial ratings will be retained or if there is a need for downgrades or upgrades. If any extraordinary events occur during the review periods, the last held ratings would be affirmed pending analysis of the new information.

Global research on this area provides inconclusive results as it differs according to region. For example, researches working in the United States market have noted that a downgrade will have a significant negative impact on share prices of the company in concern. However, an upgrade did not bring any significant impact on share prices (Holthausen and Leftwich, 1986; and Hand et al, 1992). Studies in Australia produced similar results (Matolcsy and Lianto 1995). The results are slightly different in the United Kingdom. One study of the market in United Kingdom (Barron, 1997) shows that while downgrades result in a drop in share prices, an upgrade or positive rating assessment is likely to produce a significant positive impact.

Interestingly, similar reactions have been observed in New Zealand. Here negative ratings produce downside price movements while positive assessments - either a rating upgrade or rating watch with positive outlook, boosts share prices (Elayen, Hsu, and Meyer, 2000).

As such this study's second objective is to establish if there is corollary relationship between rating pronouncements among the various classes of ratings i.e. initial, reaffirmation, downgrades and upgrades and abnormal returns. If abnormal returns exist, the study will seek to establish to differences in abnormal returns among these various classes of ratings.

1.2 Research Questions

The research questions identified below are based on the purpose and significance of the study as explained above:

- Does market place receive new information when ratings announcements are made?
- Will initial assignments, reaffirmations, downgrades and upgrades lead to any differences in terms of impact on ratings?

1.3 Scope of Study

As outlined earlier, this study will use Rating Agency of Malaysia (RAM) as the basis of its research on the multifarious relationship between rating announcements and market response. The decision was based on two overriding reasons. One is that RAM, which was established in 1990, is the oldest rating agency in Malaysia and is also highly respected by the Malaysian local investor community. Consequently it would be able to provide the researcher with a wider sample of ratings when compared to other rating agencies such as the Malaysian Rating Corporation or MARC, which was established only in 1995. Additionally choosing only one rating agency facilitates the usage of consistent set of rating data, which is based on a uniform rating process and usage.

Since its establishment, RAM has generated ratings, which are composed of both short and long term debt instruments. Among these debt instruments include Islamic debt instruments, financial institutions' ratings, senior debt rating and claims paying ability rating. This study however will focus only on short- term and long-term debt instruments; and short and long term Islamic instruments only. The decision was taken because portfolio analysis has shown that other instruments such as financial institutions rating, senior debt rating and claims paying ability rating have a very small population size, as their occurrences are rather very limited. Possible conclusions derived from such small populations might not have discernible value.

The sample size for on short- term and long-term debt instruments; and short and long-term Islamic instruments is from 1996 through 2001. The period was chosen with the understanding that data prior to 1996 would be difficult to be obtained based on existing resources and facilities.

While the time frame might be limiting somewhat, the study has chosen to broaden its sample size by including not only tradable bonds in the Kuala Lumpur Stock Exchange but also over-the-counter (OTC) bonds of public limited companies listed in the Kuala Lumpur Stock Exchange. This is because these bonds constitute a big portion of the total debt instruments, rated by RAM.

Although bond prices of those traded in the Kuala Lumpur Stock Exchange could have been accounted for in the research, the decision was taken to exclude them from the scope of the work. This was done due to the realisation that the number of bonds traded are generally negligible and even when traded the trading trend is highly sluggish. This is due to the underdeveloped nature of the local bond market and the difficulties in getting OTC bond prices.

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1.4 Limitations of the Study

As pointed out earlier due to limited resources and facilities, the decision was taken to limit the time frame for the sample size to post-1996. Inevitably this had constrained the samples size of each of the rating categories.

The sample size is further limited by the fact that not all the items within the population size of ratings done by RAM is applicable to the present study. This is because RAM in its website (http://www.ram.com.my) noted that it has rated approximately 600 ratings to-date, many of the ratings are related to companies that are not listed in the Kuala Lumpur Stock Exchange. In comparison studies done in Western countries such as the United States are able to use large sample size as there are many operating rating agencies operating in these countries. The fact that these countries have a large and active debt market related to listed companies further adds to the size of the sample size. As such sample sizes for similar studies in Malaysia and United States diverge in a significant way.

Because of the very limited number of loan stocks traded in the Kuala Lumpur Stock Exchange and the sluggish trading of such securities in the stock exchange concerned, this study does not intend to look at the impact of ratings changes on the bond price itself. In other words, the study does not take a holistic look on the impact of rating announcements on bond prices and stock prices.

The fact that the dates of ratings announcement are not consistent also a major stumbling block to this study. Perusal of local dailies clearly shows that date of announcements differ markedly among different publications. The major reason for this is that different publications tend to carry the announcements at different days. For the sake of uniformity, the decision has been taken to choose the earliest date when confronted with different announcement dates. Nevertheless, it needs to be pointed out that the difference is dates are generally not large, usually by about a day or two only.

The study will limit the event window to between five days before and five days after the announcement date. This is because the abnormal returns, if any, will show up within this window period in the case of an in efficient market. Nevertheless, departing from the norm in many other similar studies, this study will not consider abnormal returns occurring months ahead of the ratings announcements. This decision can be construed as a limitation to the study as the short event window ignores abnormal returns occurring months ahead before the actual ratings are announced.

As noted earlier, the study period encompasses a six- year time frame, ranging from 1996 to 2001. Convenience as well as resources drove the decision on the time period available. The time period chosen however does not take into account the different economic forces bearing on different time cycles.

For example, it does not differentiate between economically uncertain periods from economically stable periods (Laramie, 1992). A study based on this distinction would throw light on ratings to default measure between different economic periods. A case in point is that during this period, the Malaysian economy had undergone a range of economic growth, from relatively strong in 1996 to a slowdown in 1997 and to an almost recession in 1998 before staging rebounds on 2000 and 2001.

Finally, the statistical tools used to measure the variables and their relationship to one another had been limited to t-test. This was to ensure that the study remains straightforward and devoid on unnecessary complexity, which might deflect the basic findings sought after.

1.5 Organisation of the Study

The study has been broken into six chapters. Details of each of these parts are as below:

Chapter 1: Introduces the purpose and significance of the study. Also explored are details about the development of the research questions or hypotheses pertaining to the study. Outline about the study's scope was incorporated within this chapter.

Chapter 2: Focuses on the theoretical aspects of ratings. Among the areas touched includes objectives behind rating exercises, the benefits of ratings, the differences and similarities between Malaysian and United States rating agencies. Also touched are the types of ratings undertaken by Rating Agency of Malaysia or RAM as well as the details about the rating process such as rating changes.

Chapter 3: Explores past and current research and findings related to rating process. Most of the major research on this area is examined in detail. However due to the scarcity of research on the local markets, much of the literature review are foreign based, predominantly from United States and United Kingdom.

Chapter 4: Highlights various research methodologies. Added focus has been provided for event study methodology. There is also coverage on research hypotheses, sampling design, and procedures undertaken to collect and analyse data. There is also a section which includes pro-forma tables and summary reports that are needed in the analyses of results which needs to be done in the next chapter.

Chapter 5: Apart from providing basic descriptive statistics on the data, this chapter also analyses the data collected as well as test various hypotheses. The final section provides a comprehensive summary of the results of the study.

Chapter 6: The final chapter, which includes the summary of the study and its conclusion. Furthermore, this chapter provides material on suggestions for additional research.