CHAPTER ONE INTRODUCTION

1.1 Purpose and Significance of Study

Bond ratings are the principle source of investor information on the quality and marketability of various bond issues, Pinches and Singleton (1978). The purpose of this study is two-fold viz.:

(a) to determine whether rating announcements provide new information to the investing public.
(b) to determine the impact, if any, of initial ratings, reaffirmations, downgrades and upgrades during the event window period.

Efficient market hypothesis states that, in an informationally efficient market, information is rapidly disseminated and reflected in asset prices concerned. In this study the impact on share prices of the rated companies due to credit rating announcements by Rating Agency of Malaysia (RAM) on them is examined in detail. There are three forms of efficient markets, i.e. weak, semi-strong and strong form. The weak form asserts that stock prices already reflect all information that can be derived by examining market trading data such as history of past prices, trading volumes and short interests. The semi-strong form states that all publicly available information regarding the prospects of a firm must already be reflected in the stock price of the firm. The strong form asserts that stock prices reflect all information relevant to the firm, even including insider information available only to company insiders (Bodie, Kane and Marcus, 1999). The form relevant for this study is the semi-strong form.

Past research in this area had been done especially in the United States but no conclusive evidence had been formed. There are two different views in this area.

The first view is that rating agencies do not provide any new information other than researching on already available information relevant to the firm (Wakeman, 1992). As these agencies have access to only the available information they do not provide 'new' information to the market. In some cases, the information can be lagging on the part of the rating agency in processing the information. From this point of view, the rating agencies announcement on ratings would not cause a change on stock-returns, as the information underlying the ratings announcement is no longer 'new' to the market. One should bear in mind that rating agencies do review the ratings only periodically under normal circumstances except for unusual events. These normal reviews, hence, certainly leads to information lag from the rating agencies to the investing public.

The second view is that rating agencies access to information is not confined to publicly available information only, but also to information not publicly available (Wakeman, 1992). From this point of view it is said that rating agencies are information specialists who can gain extra 'new' information available to them during their discussions with ratees' management, visits to company premises, forecasts of income statement and balance sheet data at a detailed level otherwise not available to the general investing public etc. Hence, in this case, the provision of new information in the form of ratings is said to affect the share prices of the related companies.

In this study, the first purpose is to study and determine whether ratings provided by RAM provide 'new' information to the investing public in the form of abnormal returns in the market. Alternatively, the absence of any form of abnormal returns leads us to conclude as per the first view.

In the case of public listed companies RAM undertakes to rate their debt instruments and announces the ratings accorded in the local press. The local press then publishes the ratings concerned in the respective newspapers. This study would be able to reveal the significance of such ratings to the investing public. Non-market reaction could be taken to mean as either RAM is not providing 'new' information to the investing public or that 'new' information, if there is, is not effectively communicated in the print media to the investing public. A point to note here is that presently, all ratings by RAM are provided in a small table in the business section of the local dailies. This may call for a more proactive role on the part of rating agencies in the country in the dissemination of rating announcements.

Another significance of this study is that the study would be able to determine whether the general findings established so far in foreign studies concur with the local scene. If not, any differences in the findings from that of foreign studies can be noted.

1.2 Research Questions

With the purpose and significance of the study (as explained above in 1.1 above) in mind, the following research questions can be raised for this study:

(a) Do ratings provide new information in the market place?

(b) What is the impact of ratings on initial assignments, reaffirmations, downgrades and upgrades on share returns during the event window period?

1.2 Scope of Study

For the purpose of this study Rating Agency of Malaysia or RAM was chosen as the rating agency as it is the premier and the oldest rating agency in the country. As the pioneer agency of the country, set up in 1990, it could provide a wider sample of ratings compared to Malaysian Rating Corporation or MARC. MARC was formed at a much later period in 1995. Furthermore, the choice of one agency would permit consistency and uniformity of the rating process and usage of the rating scale for the study. It would also narrow the focus of the study to a specific agency.

Ratings carried out by RAM consist of short and long term debt instruments, short and long term Islamic debt instruments, financial institution ratings, senior debt ratings and claims paying ability ratings. However, for the study, the scope is limited to long-term debt instruments; and long-term Islamic debt instruments only. Financial institution ratings, senior debt ratings and claims paying ability ratings have been excluded because of their very small population sizes as their occurrences are rather very limited.

The time frame taken for ratings selection is from 1996 through 2001. Ratings by RAM earlier to 1996 are not feasible as the present facilities and resources do not permit the procurement of such data.

As for the debt instruments the scope of the study is not only confined to tradable bonds in the Kuala Lumpur Stock Exchange but also includes over- the- counter bonds of public limited companies listed in the Kuala Lumpur Stock Exchange. These bonds form a large proportion of the total debt instruments rated by RAM.

As explained under 'Purpose and Significance of Study' in 1.1 above, the scope of the study is actually one of relational. The share prices of the issuers of the debt instruments being rated are the ones on which the study is based. Hence, share prices of even the public listed companies that issued over- the- counter debt instruments are included in the study.

Bond prices of those bonds traded in the stock exchange could have been taken for the study. However, due to their very limited number being traded and the rather inactive trading pattern these bonds are an unlikely choice for the study. Hence, traded bonds at KLSE have been excluded from the scope of the study. Furthermore, it is also difficult to use prices of OTC bonds for this purpose.

A full review and summary of articles written in this area of study would be detailed out under 'Literature Review' in Chapter 3 of this paper.

1.4 Limitations of the Study

Despite the time frame of six years for the study, from 1996 through 2001, the sample size procured for each of the rating categories within the scope of this study is still small, as similar ratings could not be found within this time frame. Even extending the time frame may not help as some of these categories of ratings are rarely found. As explained earlier, due to the practical problems faced, data selection could not be taken beyond 1996 (backwards). Another reason is the limited population size itself. Even though RAM has stated in its website, http://www.ram.com.my, that it has rated circa 600 ratings to-date it should be borne in mind that the ratings also include a big number of ratings pertaining to companies not listed in the Kuala Lumpur Stock Exchange. Studies conducted in the United States carry very large sample sizes because of the sheer number of ratings carried out by their premier rating agencies relating to listed companies in the stock exchanges. Hence, the sample sizes of studies conducted in the United States and Malaysia are not comparable.

Though RAM was able to give a listing of rating announcements for the analysis, the ratings-watch list was not made available. A search was made in the NSTP on-line to gather rating announcements on ratings-watch and the results were far from satisfactory. Hence, ratings-watch announcements were excluded from this study.

This study does not look into the impact of ratings and rating changes on the bond price itself. The reasons being the very limited number of loan stock traded in the Kuala Lumpur Stock Exchange and the inactive trading of such securities in the stock exchange concerned. Hence, the study does not look into the totality of the impact from both angles i.e. bond prices and stock prices.

The event window period is taken as five days before and five days after the announcement date as abnormal returns, if any, are expected to be shown within this window period in the case of an efficient market. However, this study does not consider abnormal returns occurring months ahead of the ratings announcement as carried out in some studies. Hence, the short window event may be a limitation of this study as it ignores abnormal returns occurring days, months, or years ahead before or after the actual ratings are announced.

The study also does not consider the intra-industry effects due to ratings announcements. It only considers on a stand- alone basis for the listed company in question. For example, the impact of ratings announcement on rival firms or other firms in the industry is not undertaken in this study.

The study period taken in this study is a six- year time frame, i.e. 1996 through 2001. The time frame selected here is based on the convenience of getting the required data for the study. However, this study does not distinguish between economically different time periods. For example, it does not distinguish between economically uncertain periods from economically stable periods (Laramie, 1992). A study based on this distinction would throw light on ratings due to default measures between different economic periods.

This study too does not consider the impact of downgrades and upgrades within and across classes of ratings as carried out by Holthausen and Leftwich (1986); and Hand, Holthausen and Leftwich (1992). Inclusion of this would broaden the scope of this paper.

A study by Ederington and Goh, (1993) groups the downgrades and upgrades according to the reasons into 3 groups. This too is excluded in this study to keep the study focused on the two objectives only.

Lastly, the study is done based on simple statistical measures of t-test. Much of the advanced statistical measures have been precluded for the sole purpose of making the study simple and straight- forward.

1.5 Organisation of the Study

The write-up on this study is divided into six chapters and a brief outline of each of these six chapters is as follows:

Chapter 1 starts with an introduction explaining the purpose and significance of the study. It is followed by the development of the research questions or hypotheses for the study. The scope or framework and the limitations of the study follow suit in this chapter.

Chapter 2 is devoted specifically to a detailed study on the theoretical aspects of ratings that includes the reasons ratings are conducted; the advantages of ratings; the US and the Malaysian rating agencies; the types of ratings undertaken by Rating Agency of Malaysia or RAM; and the rating process including rating changes.

Chapter 3 gives a detailed review on existing research and findings done in the area of ratings including recent findings. A comprehensive and exhaustive study is conducted in this area.

Chapter 4 delves into the research methodology by detailing out some details on event study methodology. This is followed by research hypotheses, sampling design, and procedures undertaken to collect and analyse data for the study.

Chapter 5 gives some basic descriptive statistics on the data and the analyses on the data collected and the testing of the hypotheses. It concludes by summarising the results of the study.

Chapter 6 concludes the study by giving a summary and conclusion of the study. It gives suggestions for additional research and implications for the study for the Malaysian scenario.

A list of references used for the study and additional details of the study in the form of appendices are placed at the end of Chapter 6.