CHAPTER 1

1.1 Purpose and Significance of the Study

Bond Rating is process of reviewing of information on the quality and marketable of various bond issues (Pinches and Singleton ,1978). It is unbiased and subjective opinion of a particular rating agency on the creditworthiness of a company. The objective of this study is laid out as below;

a) to determine the impact, if any, of upgrades and downgrades across and within classes of ratings.

b) to determine whether the reasons for downgrades and upgrades provide difference in impact, if any.

To determine the impact, if any, of upgrades and downgrades, across and within classes of ratings.

After the initial assignment of a rating by the rating agency, the issuer is put under surveillance throughout the period till the maturity of the debt instrument. During this period the rating agency would review periodically the status of the rating and accordingly change the initial rating if the situation warrants. It can be reaffirmed, upgraded (in case of favorable developments) or downgraded (in case of unfavorable developments).

The upgrades and downgrades may take place within the investment grade or speculative grade, or across these two categories. For example, a debt instrument may be downgraded from investment to speculative grade (called fallen angels) or vice versa.

Generally, studies have shown that the market reacts stronger to downgrades from investment to speculative grades than downgrades in general (Holthausen and Leftwich, 1986). A study by Hand, Holthausen and Leftwich, 1992 found that the market reaction is stronger for multi level downgrades than single level downgrades within the speculative grades than within the investment grades. Numerous other studies on upgrades showed no significant evidence of abnormal returns including single and multilevel upgrades.

Another purpose here is then to study and determine whether such finding apply in the Malaysian scenario for upgrades and downgrades for inter and intra ratings for investment and speculative grades within and across classes.

To determine whether the reasons for downgrades and upgrades provide differences in impact, if any.

Hand et al,(1992) classified the events leading to rating announcement as expected and unexpected events. Expected events are those like company plans that have already been announced. Unexpected events are those that are forward looking that affect the company's financial prospects. In the study concerned, expected events provided no effect in terms of abnormal returns. On the other hand, the unexpected event provided significant impact for downgrades but not for upgrades.

A study by Jeremy C. Goh and Louis H. Ederinton, (1993) found no standard negative market reaction for all cases of downgrades. Downgrades due to deteriorating financial prospects caused negative market reaction as it was considered " new" negative information to investing public. Here, abnormal returns were noted. However, a downgrade due to a change in a company's leverage did not show any market reaction as it as not considered as " new" information to the market.

Here the study intends to classify the reason for upgrades and downgrades along the same lines as done in the study by Jeremy et al, (1993) and determine whether there exist any differences on the impact, if any, for the Malaysian scenario.

In the case of public listed companies RAM undertakes to rate their debt instrument and announces the rating accorded to the local press. The local press then publishes the rating concerned in their respective newspaper. This study would be able to reveal the significance of such rating 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 any, 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 column of the local papers. This may call for a more proactive role on the part of the rating agencies in the country to ensure the information is more visible.

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

1.2 Research Question

From the above explanation on the purpose of this study, the following research questions can be raised;

(a) Are there differences in rating across classes and within classes of rating for downgrades and upgrades?
(b) do the reasons for rating downgrades and upgrades cause any differences on the impact?

1.3 Scope of Study

Rating Agency of Malaysia or commonly known as RAM is the pioneer rating agency in the country, which was established in the year of 1990. As it is the premier and the oldest rating agency, it was selected to serve to purpose of this study and is believed to provide a wider sampling of rating compared to the later establishment of the Malaysian rating Corporation or MARC(1995). In order to produce consistently uniform results of the rating process and to narrow down the study to specific agency, the choice of rating agency was limited to RAM only.

The rating process of RAM consists of short term and long term debt instrument, short and long term Islamic debt instruments, financials institutions, senior debt rating and claims paying ability rating. For the purpose of this study the ratings are limited to short term and long-term debt instrument; and short term and long term Islamic instrument only. Whereas the financial institution rating, senior debt rating and claims paying ability have been excluded due to the small number of the population and the rare occurrence of it.

This study's time frame for the rating of individual issuer is from the year 1996 through 2001. Due to the limitation of resources in RAM the time frame is unable to be extended prior to 1996.

The scope of the study does not only compromise the tradable bonds in Kuala Lumpur Stock Exchange but also the over the counter bonds of public limited companies as well. This type of bonds makes up a large proportion of the total debt instruments rated by RAM.

Bond prices of those bonds traded in the stock exchange could have been taken for the study. However due to its very limited number and the rather inactive trading patterns of these bonds makes it an unlikely choice for the study. Hence, traded bond prices have been excluded from the scope of the study.

The study covers the gradation within the rating classes which are called notches and the reason for upgrades and downgrades. The reason could be prospective or historic in nature. (Jeremey C. Goh et al, 1993)

A full review of the previous study on related issues are lined up on the latter part of this paper under the chapter of 'Literature review"

1.4 Limitation of the Study

Although the time frame of the study is from 1996 through 2001, the sample size procured for each of the rating categories within the scope of this study is still small. As said earlier, the limitation was mainly due to data selection, which could not be obtained prior to 1996, and if there is the size is too small for an analysis. Even though RAM has stated in its website (http://www.ram.com.my) that it has rated circa 600 to date, it should be borne in mind that the ratings also include a big number of rating pertaining to companies not listed on Kuala Lumpur Stock Exchange.

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Another limitation of this study lies on the impact of rating changes on the bond prices itself. The limited number of loan stock listed on Kuala Lumpur Stock Exchange and inactive trading trend depth analysis of bond price reaction due to rating changes.

The rating dates also create a limitation as the date published in the media varies from one to another. This variation could be due to the newspaper itself carrying the announcement news on different dates. However, the reporting dates do not vary very much as the difference ranges between 1-2 days only.

The event window period is taken as five days before and five days after the announcement dates as abnormal returns, if any, is expected to be shown, within this window period. However, this study does not consider abnormal returns occurring months ahead of the rating 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 weeks or months before the actual rating is announced.

The intra industry effects due to the rating changes are not considered in the study as well. It only considers its effect on a stand-alone basis for the listed company in question.

Lastly, the study is done based on simple statistical measure 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 Design of the study

The paper is divide into six chapters as follows:-

The chapter 1 starts with an introduction of the paper explaining the objective and the significance. It then follows with the research questions, the scope and the limitation of the study.

The second chapter focuses on the theoretical part of the rating process in Malaysia and USA. It also explains the type of rating done by the Rating Agency Malaysia or RAM.

The third chapter is a detailed summary of the previous research conducted, which basically covers research done in USA and UK to date. However there is limited research conducted locally.

The fourth chapter emphasizes on the development of the methodology of the event study. The research hypotheses, sampling design, and procedures undertaken, to collect and analysis data for the study are explained here as well.

The fifth chapter is focused on the descriptive statistics of the data - the analyses of the data collected and the testing of the hypotheses. It finally summarizes the results.

The last chapter concludes by giving a summary and conclusion of the study. Recommendation is also included in this chapter for future research under the Malaysian scenario. A list of references used for the study and addition details of the study in the form of appendices are attached at the end of the chapter.