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Risk and Return Around Bond Rating Changes: New Evidence From the Spanish Stock Market

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Abstract: This study analyzes the effect of corporate bond rating changes on stock prices in the Spanish stock market. We explore their effects on excess of returns and systematic risk. Rating changes by Moody's, Standard and Poor's and FitchIBCA are analyzed. On an efficient market, these changes will only have some effect if they contain some new information or if they are associated to a redistribution of wealth between shareholders and bondholders. We use an extension of the event study dummy approach. Our results support the redistribution of wealth hypothesis in the abnormal returns behavior. We also find that changes in both directions cause a rebalancing effect in the total risk of the firm, with significant reductions on their systematic component.

Keywords: Credit Rating Agencies, rating changes, event study, stock returns, event study dummy approach, systematic risk, SUR

1. INTRODUCTION

The aim of this study is to explore the corporate bond rating changes effects on market returns and on systematic risk corresponding to firms listed on the Spanish stock exchange. We inquire whether the Spanish market values the information that may be contained in the re-ratings from the three largest international agencies: Moody's, Standard and Poor's and FitchIBCA.

Rating agencies assign an initial rating to new bond issues on the basis of the solvency of the issuing firms. This depends on the fundamentals of the firms and on factors related to the industry and the macroeconomic environment.[1] Afterwards, agencies successively re-evaluate corporate bonds as some of these relevant conditions change.

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1 See Crourhy et al. (2001) for an analysis of Moody's and Standard and Poor's rating systems.

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