THE INFORMATION CONTENT OF STANDARD AND POORS BANK LOAN RATINGS

by

Kerry Trevett

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Abstract

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Empirical work by James (1987) and Lummer and McConnell (1988) among others has established Bank Credit announcements provoke abnormal equity market responses, particularly for firms displaying information asymmetry. This is theorised to be due to the new information imparted to the market in the announcement. Bank Loan markets have undergone substantial change in recent years as commercial bank loans have been transformed into investment commodities. This has seen Bank loans take on more capital market product characteristics, including the use of independent Bank Loan Ratings to assess the risk of Bank Loans.

In this paper we examine whether Bank Loan Rating Announcements provide the same level of new information to markets. We find they do not provoke a response different from that seen in conventional bond rating announcements. We reason this is due to the fact that the rating agency monitoring certifies firm risk and thereby lowers information asymmetry levels overall. This may be the source of further research.

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Chapter 1

INTRODUCTION

Over the past ten years, commercial lending has undergone a startling transformation. Traditionally a one-off, bilateral "market"... the bank loan market has recently come to operate more like a capital market... [1]

Since the 1980's, the bank loan market has undergone substantial change. The process of financial innovation has markedly changed the way bank loans are treated by lenders.

Traditional bank loans were a bi-lateral relationship between a bank and borrower whereby a bank would originate a loan and retain the loan on its balance sheet. Syndication, securitisation and derivatives have allowed bank loan assets to become liquid assets transferable to third parties. 'Commoditisation' of these assets has allowed them to be on sold to create a liquid secondary bank loan market. Banks can now establish a loan, and sell tranches to other investors to maintain an appropriately risk weighted balance sheet. This process has allowed institutional investors and other non-bank lenders to originate, sell and buy bank loans.

How has this process affected the role of the Bank as a financial intermediary?

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[1] Barnish, K., S. Miller and M. Rushmore "The New Leveraged Loan Syndication Market" *Journal of Applied Corporate Finance*, 10 (1997), 79.

Finance theory traditionally notes that banks exist due to the information advantage they possess. One theory is that they have access to inside information that allows them to make lending decisions based on information unavailable to the public. Another is that they have a competitive advantage in the processing of information that allows them to act as monitors for other stakeholders, and so reduces the overall cost of financing to the borrower[2].

This information advantage has meant that Bank credit announcements provide new information to equity markets. Mikkelson and Partch (1986) noted that Bank loan announcements provided a positive equity market response, whereas announcements of other financing types either elicited no market response or a negative response. James (1987) and Lummer &McConnell (1988) confirmed the positive market response to bank debt announcements.

Since then, empirical studies have further refined the circumstances wherein bank loan announcements impact firm value[3]. It has been found that the impact of bank loan announcements is dependent on the level of information asymmetry displayed by a firm. Typically this is in small, young firms with high growth options in developing industries[4].

These papers reinforced the fact that it was the action of the bank in providing loans to firms, and changing the terms of those loans that provided market information rather than the action of the firm itself in selecting bank debt. That is, if the bank elected to lend money to a firm, this acted as *certification* of the firm's activities.

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[2] See for example Fama (1985), Leland and Pyle (1977), Campbell and Cracaw (1980) and Diamond (1984). Datta et al (1999) show the firms with bank debt have lower public debt financing margins.

[3] See for example, Lummer and McConnell (1988), Wannsley, Elayan et al (1993), Best and Zhang (1993)

Preece and Mullineaux (1994) foreshadowed a change in the structure of Bank loan markets by concluding that non-banks possessed the same information as banks but were less successful in originating bank loans. This was particularly true as information improvements lowered the price of credit analysis and monitoring.

Several factors have reduced the bank advantage: increasing levels of standardisation of bank loans, the introduction of bank loan ratings, growing loan market liquidity and a flat yield curve which makes bank loans more saleable in secondary markets to institutional investors.

Chaffin (1999) notes:

In recent years, merger and acquisition activity has... [increased]... and syndicated loans have proved to be the vehicle of choice to close those deals. Companies favour loans because of secrecy, because their pricing. [is more stable]. More important, unlike bonds, loans can be repaid early, and without penalty... Such deals have brought increased flexibility to companies; they have also brought tremendous opportunity to bankers who are looking to grab the original loan fees, but also those for the future debt or equity underwriting and those for advising on the merger or acquisition. [5]

Chaffin thereby indicates the confidentiality and flexibility provided by the bank loans framework makes them popular with both borrowers, investors and originators.

An important part of the sourcing of bank loan business by non-banks is the 'outsourcing' of risk assessment to independent rating agencies such as Standard

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[4] Krishnaswami et al (1999)

[5] Chaffin (1999), p 4

and Poor's. This allows better analysis of the risk/return profile in secondary markets and is increasingly driving pricing in syndicated loan establishment[6]. It allows investors to compare bank loan investments with other investment alternatives.

The Corporate Credit Rating measures the overall firm risk of default. The Bank Loan Rating is derived from the Corporate Credit Rating and is then notched or adjusted for collateral levels that indicate the likelihood of recovery in the event of default. For example, a firm with a Corporate Credit Rating of B may have a Bank Loan Rating of B+ if there is sufficient collateral in the loan structure. Correspondingly, as Bank debt ranks ahead of Subordinated and Senior debt in a liquidation, the ratings applied to these instruments my reduce to B-, as they would receive a lesser share of the collateral in the event of default.

Empirical research has indicated that stock prices tend not to be influenced by bond ratings. The exception to this is a negative market response to bond rating downgrades. The theoretical underpinning for this being that firms will not divulge bad news until the rating change introduces it to the market, while good news is readily supplied to the market, and the rating change acts as certification of what the market already knows and what is already priced into market prices[7].

Bond ratings (and bank loan ratings) are specifically designed for bond markets, so any information provided to equity markets is peripheral. A firm's risk of default increases (leading to a rating downgrade) where:

- When the volume of expected future cashflows deteriorates, or

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[6] Miller, S. "Bank Loan Ratings Surge: Leveraged Loans Come of Age as an Asset Class" *Standard and Poor's Credit Analysis Reference Disc*, 1997

[7] see for example Ederington and Goh, (1998), Holthausen and Leftwich (1986)

- When expected future cashflows do not change, but they become more risky.

Both situations increase the risk of a bond investment that is subject to fixed returns at the coupon rate.

The first option also represents deterioration in the value of equity as measured by the Net Present Value of expected cashflows. The latter will enhance shareholder value however in accordance with the risk/return framework. Chandra and Nayar (1998) show that most bond rating decreases are due to a change in the volume of cashflows, which also decreases the value of equity. The exception to this is at lower Credit Rating levels where further deterioration in Credit rating may also be associated with increased riskiness in cashflows.

In this paper we examine the influence of Bank Loan Ratings on stock value.

Previous research has indicated that bank loan announcements convey new information to equity markets. In the new bank loan market, have Bank Loan Rating announcements replaced the Bank Loan announcement in providing new information? If this is true, then it can be argued that rating agencies also possess the same information advantages as banks, and the competitive advantage previously possessed by banks has changed.

If this is true, then the question can be asked whether banks possess any advantage in the bank loan market.

We hypothesize that the corporate credit rating, which measures the firm's risk of default, will dictate the response of equity markets to ratings, rather than that of the Bank loan rating. This is because the corporate credit rating measures the

firm's overall risk of default, whereas the Bank Loan Rating is instrument specific and not directly related to firm value except insofar as it influences the CCR.

Any information included in the Bank Loan Rating will also be accounted for in the Corporate Credit rating. This is because both are derived from the same information source (rating agency) with the same level of information about the firm. In accordance with the preceding evidence, we expect to see no response other than where the CCR worsens.

The impact of a worsening of the Corporate Credit rating will depend on whether the reason for deterioration is equity enhancing (increased risk), or equity depressing (lower expected cashflows).

We theorise that the commodotisation of Bank Loans has reduced the information included in these announcements. The Rating procedure has lessened information asymmetries, as it provides a mechanism for the risk of a firm to be disclosed publicly via a rating without the firm having to disclose the details of confidential information publicly. This is an ongoing monitoring procedure that has essentially replaced that provided by Banks credit announcements in the past.

We can therefore suggest that banks have lost their information advantage due to technological advances and the advent of rating agencies that can access the same inside information[8].

If the rating agency has reduced information asymmetry, what is the advantage of bank debt? This question is answered by Chaffin, above, and the answer lies in

[8] Ederington and Yawitz(1987), Holthausen and Leftwich, (1986)

the structure of the debt. It also lies in smaller debt issues for which economies of scale make bank debt the cheapest financing option[9].

Greater monitoring, collateral, prepayment arrangements and covenants of bank loans ensure higher recovery in case of default compared to other debt financing instruments[10]. This provides bank debt with an attractive risk/return ratio for investors. In return, borrowers are allowed early repayment, LIBOR pricing and increased monitoring.

We use event study methodology to investigate the impact on firm value of Bank Loan Rating events (new Bank Loan Rating, improvement and worsening in Bank Loan Ratings).

We also complete a multi-variate regression of the results where we control for the size of the loan facility and the level of rating of the firm, as well as firm outlook and industry.

In this paper, Chapter Two provides a review of literature covering theory and empirical findings on the following aspects of this topic:

- The market value impact of Bank Credit announcements.
- Type of firm preferring bank debt.
- The market value impact of Bond Rating announcements.
- The Bank Loan Rating process.
- Change in the Bank Loan market.

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[9] Krishnaswami et al (1999)

[10] This is reflected in the evidence summarised by Krishnaswami et al (1999) which shows firms using bank debt are smaller, younger, less likely to be monitored by regulating agencies and with higher information asymmetries. The ratings dataset provided in this report also indicates the speculative nature of firms with bank loan ratings. Bank debt is shown to have a higher Sharpe Ratio than equity or other debt types.

- The Bank Loan establishment process.

Chapter Three provides a Testable Hypothesis, Chapter Four reviews the data collection process, Chapter Five reviews the methodology used. Chapter Six presents the results and provides discussion. Chapter Seven concludes.