THE INFLUENCE OF FINANCIAL RATING AGENCIES ON INVESTMENT BEHAVIOR

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Abstract

The evaluations and forecasts of financial rating agencies represent an interesting and also an important component of the contemporary world economy(Sechel, 2010). *This truth became very relevant from the perspective of nowadays economical and financial crisis. In this context, the evaluations have a determinant role for estimating the associated risks for financial instruments. Actually, the rating represents the probability that an entity can ensure the payment of its financial obligations towards its creditors. We could say that, the evaluations of different entities for establishing a rating, has became an extremely actual subject, in the crisis conditions. This information have a significant contribution for the investors horizon but, we can take into consideration the question about the legitimicy of this activity, and also a natural question that arrives from here: can we talk about stock market manipulation, based on these evaluations?*

Key words: Financial Rating Agencies, Bond Prices, Investment Decision, Financial Crisis, Fraud

JEL Classification: G24, G11, G32

1. FINANCIAL RATING AGENCIES

The activity of financial rating agencies in providing notes, is based on estimates of the associated risks for the various economic activity of an entity. These estimates are published as analysis, that can be easily interpreted by the audience everywhere, because of their international character.

The ratings given for the variousentitieswhich can beevaluated, and also their classificationbythreeof the majorrating agenciesmarket: Standard & Poor's, Moody'sandFitchare presented in thefollowing table. The bond ratingbyStandard &Poor'sis markedfromAAA(the best) to D(the lowest), and the notations of the othertwo rating agenciesarevery similar(Moody’s andFitch).

Qualifier type	*S&P Rating*	*Moody’s Rating*	*Fitch Rating*	*Observations*
INVESTMENT Grade				
Highest grade	*AAA*	*Aaa*	*AAA*	*In this casethe issuer definitely hasthe financialcapacityto cope withunpredictable problemsarising inhis workandhas noproblemin payinginterest for the loans*

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				committed.
High grade	*AA (+, - or 0)*	*Aa*	*AA*	*In this case, the issuer has astrongcapacityto faceits financialcommitments.*
Higher intermediate level	*A (+, - or 0)*	*A*	*A*	*The overallfinancial conditionof the issuerischaracterizedby a slightuncertaintyregardingchanges thatmay occurover alonger periodof time.*
Average (medium) level	*BBB (+, - or 0)*	*Baa*	*BBB*	*In this case, the issuer's financial capacity is acceptable, but the risk of an imbalanceinits economicconditionsis quite high.*
SPECULATIVE Grade				
Lower average level	*BB (+, - or 0)*	*Ba*	*BB*	*Regardingthe ability toface the financial obligationsincurred, the issuer's situationisalmost uncertain.*
Speculative level	*B (+, - or 0)*	*B*	*B*	*The financial situation ofthe issueris increasinglyfragile, but in present it has the capacityto honorits obligations.*
Lower level	*CCC (+, - or 0)*	*Caa*	*CCC*	*The issuer's financial situation is vulnerablein allits categories.*
Very speculative level	*CC*	*Ca*	*CC*	*The issuer's financial situation is very vulnerable.*
Lowest level	*C*	*C*	*C*	*In the next period, the issuer will enter in bankruptcy.*
In defauld	*D*		*D*	*The issueris alreadyinsolvent.*

Table1. Rating clasification from the perspective of Standard & Poors, Moody's and Fitch Agencies

Source: Standard & Poors: (www.standardandpoors.com, 2013)
Moody's :(www.moodys.com, 2013)
Fitch :(www.fitchratings.com, 2013)

There are situations where the same company is assessed by several agencies, most often given mark is very close, if not the same.

Acording to the Explanatory Dictionary of Romanian Language, the rating is an english word, which means „assessment" or „apreciation". Through this evaluation, it is wanted to be realised a proces that include several steps, as analysis of associated risks for an entity, and at the end of this process, the analists can reach at a result in the form of notes (rating).

In addition to the character most often objective for the notes gaved, the rating agencies practically provide an alternative at assessments made by banks (for example, before granting a financing loan) or for standard audit services, which are designed to show any problems within an entity. On the other hand, rating agencies provide a comprehensive vision about the situation of national economies, realizing relevant correlations between them. The macroeconomic vision on both of a national territory, and the multinational companies, is welcome in the terms of internationalization and globalization of economic activities.

Associated with capital markets, credit ratings represent a process which assesses the risk associated with a financial security instruments, this assessment involves a granting of a qualification, depending on the characteristics of that instrument and also on the grid set for evaluation.

Regarding the economic and financial crisis and the impact of financial rating agencies on it, we can say that this is a highly controversial approach. But really, we can talk about the fact that rating agencies and assessments made by them were a major cause of this crisis? Definitely we can talk about the fact that the financial rating agencies have contributed significantly to the deepening of the crisis. There are a lot of examples in which, at least on the declarative perspective of own protection, the rating agencies have published reports evaluating companies giving a lower rating than under normal conditions. Hence the avalanche participants of securities market as sellers in the markets.

The case of Lehman Brothers, known for its intense media coverage on this topic, is perhaps the most relevant example of the inconsistence of the evaluations made by a rating agency, with the reality. The month of september 2008 is likely to remain long in investors mind. Lehnam Brothers was the fifth american bank as importance, and in september 2008 it asked for bankruptcy protection. The bank had liabilities of over 600 billion dolars, and the situation became critical after the crisis affected all its powerful assets. Lehman Brothers bankruptcy was the biggest in United States history. On september 12, 2008 - Standard and Poor's has added the bank into it's monitoring list, after a serious fall of share prices of Lehman Brothers, and on 15 september, in the same time with the bankruptcy announcement, the rating agency granted the bank from „A" to „D".

In the chart below, you can see the evolution of Lehman Brothers shares, focused only on the period september – november 2008, to highlight the events that happened. Shares have lost almost all their whole value (from 16 dolars/share reached at 0.06 dolars/share).

In a large extent it can be considered that the rating agencies have apart of blame fort he financial crisis because they didn't discover the so-called toxic assets managed by companies evaluated. In this case, the problem born here refers to the investor's financial security. The mission of rating agencies was precisely this, to detect and identify any possible financial products dressed in a positive aura so that they can be sold tounsuspectinginvestors.

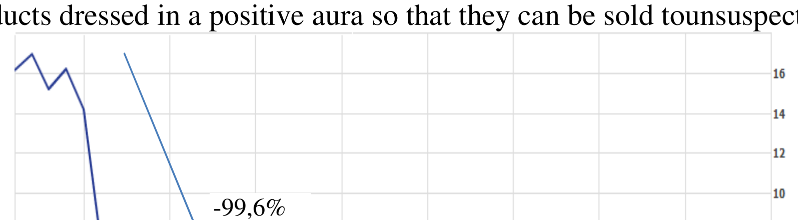

Figure 11.The price evolution of Lehman Brothers shares

- For the period: september – november 2008 -

Source: (www.finance.yahoo.com, 2013)

For these reasons, maybe it won't be exaggeratedassupervisor authorities have been regulated in some waythe financial rating agencies. We saw abovehowthe investment process,can beseverely affected byinaccuraciesincurredin assigning ratingsby agencies.

Throughtheir work, the rating agencies givenotes(classifies) variousentities such ascompanies, institutions or governments of the states, but they alsoratethe issue of shares, bondsandstructured products,thereforethe impact ofinadequateratingscan be devastatingfor the financial market. Correlatedwith the crisis begun in2007, therating agencies havetaken action, from our point ofview,too late.When theybegan todowngradebanks, financial securitiesand in fact theworld economy,came laterthanthe first signs ofeconomiccollapse. Their rolewasjustto predictwhat wouldhappen inthe autumn of2007, butwith their attitudeit has been shown that the goal have not been achieved. Ifthissystem wouldworkasexpected,the rating agenciesshouldbe identifiedthe so-calledtoxicassetsand they would be exposedthe problemsfor the whole world. Here, it remainsabig question markon adilemma: the rating agenciespredicted or notwhat wasto happenin the fallof 2007 andif they havepredicted, they acted onthe marketstrictlyfor personalinterest or for the interests of their clients? Perhapsfor this questionwill be very difficultto find an answerin the next years because aspects like this often remainhiddenfor long period of time.

Besides thosealreadyexposed aspects, an important issueis thefunding sourceof the rating agencies. It is known that the rating agencies have as a source offinancingthe contracts withthe banks, institutions, governments, etc.to whom theyprovidetheir services.Butreally, how objectivean assessmentcould be as long as it iscontrolled byLehmanBrothersand also paidby it? Of course, acertain subjectivityexistedandcontinue to existas long asthe funding sourceof rating agenciesis not coming fromthe opposite side, from those interested ininvestingtheir capital.

2. LINKING THE INVESTMENT DECISIONS WITH THE RATINGS PUBLISHING

The ratings publishing is highly followed by all the participants of the financial market. With the information incorporate, rating contains a significant dose of forecasting, and this is the reason why many investors who take into consideration these evaluations and who guide their decision base on this facts, may anticipate quite well the evolution of the bond prices, or the yields forecasted for such instruments, in the near future. In fulfilling this function, we can say that rating agencies have an important role in taking the investment decisions by investors.

The investment behavior is highly complex, investors react to an extremely large variety of stimulus, but the investment decision should always be fundamentaly based (Prisacariu, Ursu, & Andries, 2008). In this sens, an evaluation report issued by a rating agency is often regarded as a primary motivation for investment decision (Lăzărescu, 2003). An analysis of investment behavior show that investors expect a confirmation of their belief from the rating agencies, with their published rating. This fact can be explained on the basis that the rating agencies have access to confidential information about economic and financial situation and also perspectives of issuers evaluated.

A particlar importance has zalso the so-called supervising list (watchlist), in which there are nominalised the companies followed for a reevalution of their situation. The inclusion of an issuer on this list, does not require the granting of a new rating, this will only happen after the end of the evaluation and publication of results.

3. THE EFFECT OF RATING CHANGES ON BOND PRICES

There are several scientific research, statistical and mathematical based, showing a clear dependence between the rating change moment for an issuer of debt instruments (Followill & Martell, 1997), and the evolution of prices of such securities, on a regulated market. The first one who analised from the statistical point of view, the determined role of changing rating companies, through the evolution of debt instruments prices, was Weinstein, in 1987, but the premises of his research were taken up by many others researchers, including John Hand Robert Holthausen, Richard Followill, and Philippe Jorion. All of them started from the hypotesis of existing a dependence between the rating changes and the bond price

(Hand, Holthausen, & Leftwich, 1992), and the findings showed that the bond price change is more visible after a period of several months, and not at the time of publication of the new rating. Immediately after the rating change, for a relatively short period of time, the impact on price may be considered negligible.

More often, the moment when a rating agency will make known it's rating for a particular issuer, is known (Jorion & Zhang, 2007). With very little time before the announcement is made public, and the forecasts relate to a potentional deterioration on rating, the price of debt securities react seriously, showing an increase in volatility. From the moment when the volatility increase, until the official announcement, the price of securities made a movement for 40-50% of the entire movement. Here's how, after the public announcement, from the whole movement of the instrument price, there remains approximately 50-60%.

Just like the stock market, a negative information about an issuer, determine a lower price for that share, even temporarily, so the bond market is the same, when a rating change is lower, investors are tempted to sell those securities. What it is formed in this situation is the so called „herd effect" or „snowball effect", in which investors influence each other and they take similar decisions. On the other hand, the reduction on issuer rating is much more significant than the increasing prospects for rating. Consequently, the effect of increasing rating, will not trigger the purchase operations for the financial instruments implicated, long before the public announcement of the new rating. The explanation of these phenomena can be given by the fact that when degradating of a rating , credit risk associated with financial securities, is given by a less probability on collection of loans, that is why the investors react more impulsive, and try to sell those securities. On the other hand, an increase in the rating given to an inssuer of debt securities, certifies the potentional of the company to honor its financial obligations until maturity, otherwise this is the reason of holding these assets in their portfolios.

4. CONCLUSION

The financial rating agencies play an important role in the global economy because they have great influence over investment decision of market participants. In most of the times, from the moment of delivery a new rights issue, they have associated a rating, gived by one or more such agencies. Here we can see the importance of rating agencies in a properly evaluation of the companies. A wrong rating, gived in sense of a lower evaluation for a company, makes that issue never to succeed among investors. It can thus say that rating agencies provide an added value in financial markets, due to the evaluations made.

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