

Regulation Fair Disclosure's Effect on the Information Content of Bond Rating Changes

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The paper in a Nutshell

When the SEC implemented Regulation Fair Disclosure (Reg FD) in 2000, bond rating agencies (RA) were exempt from the law. The key question is: did they (i.e. RA) continue receiving the private firm information necessary for accurate credit default assessments or did firms compensate their reduction in releasing private information with increased or better publicly-released information?

- The paper provides the first empirical investigation of the impact of Reg FD and bond rating agencies' exemption on the response of bond yield premia to bond rating changes. They find:
 - for downgrades → the impact of Reg FD is related to firm size: small firms experienced a weaker bond yield premia response
 - for upgrades → no significant difference before and after the Reg FD

- My major concern is the R^2 of the regressions (it ranges from 0.012 to 0.031). That implies that the fraction of variance that is left unexplained by the model is close to 97%.
- In the sample, the usable observations in the Pre-Reg FD period are 466 for downgrades and 642 for upgrades compared to 10,121 usable downgrades and 7,497 upgrades in the Post-Reg FD.
- In the descriptive statistics for the upgrades, on average the Premium Change in the Post-Reg FD (that is -3.76) differs significantly from the Premium Change in the Pre-Reg FD (only 0.64). How to reconcile that with the fact there is no significant change for the upgrades?

Discussion II

- When a rating agency changes bond ratings, it could well be that other agencies do the same. Therefore, the 11-days window related to the rating change operated by an agency may overlap with the 11-days window rating change operated by another agency. Then, variations in yield premia could (in part) contain information on multiple-agency rating changes. It would be interesting to quantify (or to disentangle) this additional effect.
- The downgrades evidence related to firm size suggests the presence of non-linearities in the response of yield premia to credit changes: restricting to post-Reg FD data only, that could be confirmed by the inclusion of a quadratic regressor, namely the squared deviations of Log Size from its mean, in the two models.
- Idea for future research: an event study methodology based on the introduction of the Dodd-Frank act with emphasis on the volatility of bond yield premia as well