3rd International Conference on Emerging Trends in Engineering and Management Research
Institution of Electronics and Telecommunication Engineers, IETE Indiranagar, Pune, India (ICETEMR-17)
30th July 2017, www.conferenceworld.in ISBN: 978-93-86171-55-9

IMPORTANT RESEARCH AREAS RELATED TO CORPORATE CREDIT RATINGS

Rahul Gupta[1], Sumit Sharma[2]

[1]*Research Scholar, Department of Commerce, University of Jammu, (India)*
[2]*Branch Manager, Syndicate Bank, Punjab, (India)*

ABSTRACT

The credit risk of the borrower is an important factor taken into consideration while taking investment decisions by the investors. Investors attach high value to the systematic assessment of credit risk. A large number of researchers have used and studied credit rating as a proxy of the credit risk. Given the importance of credit rating as an indicator and measure of default probability of the borrower, it developed as an important research area in the past few decades for academicians as well as professional institutions and regulating bodies. The ratings assigned to companies for assessment of their ability and willingness to meet their financial obligations are called as corporate credit ratings. The aim of the present study is to highlight and explore the various research areas related to corporate credit ratings by summarising much of the available literature related to the topic.

***Keywords*: Bond prices, corporate credit rating, determinants, financial obligations, research areas.**

I. INTRODUCTION

With the increasing market orientation of the present economies, investors place high value on the systematic assessment of two types of risks, namely — "business risk" arising out of the "open economy" and linkages between money, capital and foreign exchange markets and "payments risk or credit risk". The risk of default to honour the debt obligations by the borrower when they fall due is called as credit risk and is considered as an important factor for investment decisions of investors (Kumar & Rao, 2012). The credit risk is one of the most important areas of financial research in recent times (Cantor, 2004). Most of the studies in financial research have used credit rating as a proxy measure for credit risk (Murcia et al., 2014). The term 'Credit Rating' comprises two words 'credit' and 'rating'. Credit is trust in a person's ability and intention to pay or reputation of solvency and honesty. Rating means estimating worth or value of, or to assign value to classifying a person's

position with reference to a particular subject matter. The Rating is usually expressed in alphabetical symbols. Thus, Credit Rating can be defined as an expression of an opinion through symbols about the credit quality of the issue of securities or company with reference to a particular instrument. It is the opinion of a rating agency about the ability and willingness of the issuer, may be a corporation or state or city government, to meet its financial obligations in full and on time (Standard & Poor's, 2010). It generally reflects the credit worthiness of the borrowers and the probability that the borrowers will honour the principal and interest liabilities on due dates (Kaur & Kaur, 2011). If the borrower is a company, the rating assigned to the evaluation of its creditworthiness is referred to as corporate credit rating. It represents an assessment of the ability and willingness of governments to meet their financial obligations. Corporate credit rating is important for investors and lenders as it provides them superior information at low cost, acts as the basis for proper risk and return trade-off and induces healthy discipline on companies (Gordon & Natarajan, 1999; Bhalla, 2008). Further, rating agencies help in the development of capital markets when they provide a reliable opinion about the default likelihood of the companies and their credit instruments. This consequently results in reducing the information asymmetry of the investors and enhances their confidence in investing in the rated instruments (Papaikonomou, 2010). Due to these reasons, credit rating is continuously being focused as a topic of research by academicians and professional and government institutions. So, the objective of the present study is to identify the areas of research related to corporate credit ratings being focused upon, on the basis of the review of literature available in this context.

II. VARIOUS AREAS OF RESEARCH RELATED TO CORPORATE CREDIT RATINGS

Cantor (2004) identified six major streams of the research around credit ratings, which include understanding rating transitions, rating determinants and stability, evaluating credit ratings role as portfolio governance tools, relation of bond prices and spreads with credit ratings, impact of changes in credit ratings on changes in market prices, and related to sovereign risk and ratings. The present study extends/modifies the work of Cantor by adding new literature and by highlighting areas of research being presently focused upon and that too specifically related to corporate credit ratings. On the basis of a review of available literature, following important research areas around corporate credit ratings have been identified:

2.1 Factors determining corporate credit ratings

One of the most important research areas related to corporate credit ratings being explored in the recent past has been the identification of factors affecting the ratings. Various non-financial determinants are identified by a number of studies. Czarnitzki and Kraft (2004) and Al-Najjar and

Elgammal (2013) explored the effect of innovation measures on firm's credit rating. Both studies found that innovative firms achieve better ratings. However, they also established that innovation beyond a certain optimum level or too many innovative activities reduce the ratings as these are also subject to possible failure. Grunert, Norden and Weber (2005) in their study found that non-financial factors play important role in internal credit ratings issued by German banks. They further stated that combined use of financial and non-financial factors lead to more significant default prediction than the single use of financial or non-financial factors. Roy (2006) conducted a comparative study to investigate whether there exist a difference between solicited and unsolicited bank ratings. He found that solicitation by a bank affects its credit ratings and the unsolicited bank ratings are lower than the solicited ones after controlling for observable bank characteristics. Relationship of corporate governance measures with firms' credit ratings is investigated by Ashbaugh-Skaife, Collins and LaFond (2006) and Aman and Nguyen (2013). Both studies revealed that good governance has a strong association with higher credit ratings. Among the different governance attributes examined, institutional ownership and disclosure quality emerged as most significant attributes. Further, they also found that credit ratings have a positive relationship with governance attributes like board size, accrual quality, takeover defences, earning timeliness, board independence and board expertise. They also reported a negative relationship of credit ratings with number of blockholders possessing at least a 5% ownership in the firm and CEO power on the board. Effect of increased competition in the rating industry on the quality of credit ratings has also been examined in a few studies, namely Becker and Milbourn (2011) and Xia (2012). Both these studies found significant improvement in the quality of ratings issued by incumbent issuer paid rating agencies following the entry of an investor paid rating agency in the market. However, rating quality reported to deteriorate following the entry of another issuer paid rating agency. Bar-Isaac and Shapiro (2012) theoretically studied the changes in incentives of credit rating agencies to provide quality ratings in different environments. The study established that a credit rating agency is more likely to issue less accurate ratings in the presence of factors like high income from rating fees, tough competition in the labour market for analysts and low default probabilities for the securities rated. Attig et al. (2013) analysed the effects of corporate social responsibility on firms' credit rating. The results of the study revealed that credit rating agencies tend to award relatively high ratings to firms with good social performance. Further, they also remarked that the individual components of CSR which relate to primary stakeholder management matter most in explaining firms' creditworthiness. Recently Behr, Kisgen and Taillard (2014) explored the effect of Securities and Exchange Commission's (SEC) certification of credit rating agencies on the quality of credit ratings. Results indicated that market power derived from such certification leads to lower ratings quality.

Apart from the aforesaid studies conducted on non-financial factors, a few studies have also explored the role of financial factors in determining corporate credit ratings. For instance, Adams, Burton and

Hardwick (2003) in their study identified the factors that explain the ratings assigned to UK-based direct insurers by two of the world's leading rating agencies- A.M Best and S&P. Regarding A.M Best's ratings, they found profitability, liquidity and organisational form to have a positive and significant association with credit ratings. However, regarding S&P's ratings, they reported that profitability and liquidity are positively and significantly related to while leverage is negatively but significantly related to credit ratings. Another study by Roje (2005) examined the role of accounting variables in predicting long term credit ratings. The study revealed that profitability, size and tangible book value to total assets are positively related, whereas leverage, long term debt, current ratio, volatility of earnings and sales growth are negatively related to credit ratings. The study also remarked that all the variables are significantly associated with credit ratings. Further, leverage and sales growth are reported to be less important than other variables by the study. A study by Bone (2010) tried to verify whether or not it is possible to predict corporate ratings using a set of financial indicators in the case of a World renowned Argentine Oil Company. The study found earnings (EBITDA) and short term debt over total debt (STD/TD) to be the most relevant indicators in predicting the selected company's rating. Al-khawaldeh (2012) evaluated the impact of the firm characteristic factors upon the credit rating of Jordanian firms. The study concluded profitability to be positively associated with credit rating, and leverage and loss propensity to be negatively related to credit ratings. Further, size and growth potential are reported to be strongly and positively associated with credit ratings whereas the type of sector and audit found to have no relation with credit ratings. Recently a comprehensive study by Murcia et al. (2014) in Brazil reported five factors, namely leverage, internationalisation, performance in the financial market, profitability and growth as significant determinants of credit ratings. Another latest study by Venkiteshwaran (2014) examined the impact of turnover in corporate assets on its credit rating. He found that higher turnover in corporate assets has a positive effect on the likelihood of higher credit ratings.

2.2 Relating bond/equity prices to corporate credit ratings

The response of bond/equity prices to changes in non-sovereign credit ratings is examined by a group of studies, namely Creighton, Gower and Richards (2007), An and Chan (2008), He, Wang and Wei (2011), Afik, Feinstein and Galil (2014) and Cohen (2014). Creighton, Gower and Richards (2007) and Afik, Feinstein and Galil (2014) evaluated the response of corporate debt and equity prices to the announcements of credit rating changes. However, Creighton, Gower and Richards (2007) in their study found that prices of corporate debt and equity respond in the expected direction after the announcement of credit rating changes in the Australian financial markets, where as Afik, Feinstein and Galil (2014) in their latest study concluded that the equity and bond markets do not react to positive rating announcements and market reviews but respond to downgrades by local Israeli credit rating agencies'. Further, effects of credit ratings on initial public offering (IPO) pricing have been

examined by An and Chan (2008). They found that IPOs of firms with credit ratings are significantly less underpriced than firms without credit ratings. He, Wang and Wei (2011) and Cohen (2014) investigated the effects of debt market credit rating changes on the equity market information asymmetry. The researchers reported that bond rating changes affect the information asymmetry of stock trading. They also remarked that the degree of change in stock information asymmetry is positively associated with the magnitude of bond rating changes.

2.3 Effects of Corporate Credit Ratings on Other Corporate Aspects

Some previous studies also examined the effects of corporate ratings and their changes on other different aspects like incentives, capital structure decisions, access to funds, loan syndicates, etc. For instance, Kang and Liu (2005) in their study examined the relationship between corporate credit rating changes and CEO incentives. The researchers found that credit rating changes affect CEO incentives significantly. They also concluded that CEO incentives tend to increase subsequent to credit downgrades and decrease after credit upgrades. Kisgen (2006) in his study reported that credit ratings directly affect capital structure decisions by managers. Hartarska and Nadolynk (2008) studied whether ratings help rated micro finance institutions to raise funds. The results revealed that all the agencies have not an equal impact on micro finance institutions' ability to raise extra funds. The study also concluded that subsidizing ratings do not help micro finance institutions to raise more funds. Further, the relative importance of credit ratings versus stock exchange listings in reducing information asymmetry is analysed by Bosch and Steffen (2011). They investigated that whether loan syndicates are larger if the firms are rated than stock exchange listed. They found that unrated listed firms have significantly lower syndicates than listed and rated firms. Similarly Korkeamaki, Poyry and Suo (2014) in their study concluded that loan syndicates to firms with credit ratings found to have a larger number of participants, indicating that ratings alleviate problems relating to information asymmetry. Credit ratings also found to be positively associated with excess value of diversification or with the lower negative effect of diversification by Chou and Cheng (2012). Recently, Abad and Robles (2014) evaluated the impact of credit rating changes on the risk of re-rated firms. The researchers reported that all types of rating announcements, whether positive or negative, have significant impact on systematic and idiosyncratic risks indicating that rating agencies provide new information to the market. Also in a latest study conducted by Agha and Faff (2014), the interactive effect of financial flexibility and credit re-ratings on corporate investment and financing decisions is investigated. It is found that financial flexibility interacts with credit re-ratings asymmetrically. Specifically, a credit rating upgrade of financially flexible firms found to be followed by a reduction in cost of capital, increase in their capital expenditure and issuance of net debt versus net equity whereas a downgrade is not followed by any significant changes.

III. CONCLUSION

Corporate credit rating plays a very important role for investors and lenders by supplying them superior information at low cost and by inducing healthy discipline on companies. By providing a reliable opinion about the default likelihood of the companies and their credit instruments, rating agencies help in the development of capital markets. This further results in reducing the information asymmetry of the investors and enhances their confidence in investing in the rated instruments. Realising such great importance to investors and users, ratings assigned to companies has evolved as a focus of research in the recent past. So, the present study tries to summarise the literature available to the best of knowledge, related to the corporate credit ratings in order to highlight the major research areas around the corporate credit ratings. The study finds three important areas of research related to corporate credit ratings being continuously focused upon by the researchers which are factors determining corporate credit ratings, relating bond/equity prices to corporate credit ratings and effects of corporate credit ratings on other corporate aspects. The study can provide insight to the future researchers about the areas being sufficiently explored so that they can identify new areas of research related to corporate credit ratings.

REFERENCES

[1] Abad, Pilar, and M. Dolores Robles, 2014, Credit rating agencies and idiosyncratic risk: Is there a linkage? Evidence from the Spanish Market, International Review of Economics and Finance 33, 152-171

[2] Adams, Mike, Bruce Burton, and Philip Hardwick, 2003, The determinants of credit ratings in the United Kingdom insurance industry, Journal of Business Finance & Accounting 30, 539-572.

[3] Afik, Zvika, Itai Feinstein, and Koresh Galil, 2014, The (un)informative value of credit rating announcements in small markets, Journal of Financial Stability 305, 1-15.

[4] Agha, Mahmoud, and Robert Faff, 2014, An investigation of the asymmetric link between credit re-ratings and corporate financial decisions: “Flicking the Switch” with financial flexibility, Journal of Corporate Finance 29, 37-57.

[5] Al-khawaldeh, Abdullah Ash-shu’ayree, 2013, Determinants and impacts of internal credit rating, International Journal of Financial Research 4, 120-131.

[6] Al-Najjar, Basil, and Mohammed M. Elgammal, 2013, Innovation and credit ratings, does it matter? UK evidence, Applied Economics Letters 20, 428-431.

[7] Aman, Hiroyuki, and Pascal Nguyen, 2013, Does good governance matter to debtholders? Evidence from the credit ratings of Japanese firms, Research in International Business and Finance 29, 14-34.

[8] An, Heng (Hunter), and Kam C. Chan, 2008, Credit ratings and IPO pricing, Journal of Corporate Finance 14, 584-595.

[9] Ashbaugh-Skaife, Hollis, Daniel W. Collins, and Ryan LaFond, 2006, The effects of corporate governance on firms' credit ratings, Journal of Accounting and Economics 42, 203-243.

[10] Attig, Najah, Sadok El Ghoul, Omrane Guedhami, and Jungwon Suh, 2013, Corporate social responsibility and credit ratings, Journal of Business Ethics 117, 679-694.

[11] Bar-Isaac, Heski, and Joel Shapiro, 2012, Ratings quality over the business cycle, Working paper, NYU and University of Oxford.

[12] Becker, Bo, and Todd Milbourn, 2011, How did increased competition affect credit ratings?, Journal of Financial Economics 101, 493-514.

[13] Behr, Patrick, Darren J. Kisgen, and Jérôme P. Taillard, 2014, Did Government regulations lower credit rating quality?, SSRN Electronic Journal, 1-50 (http://ssrn.com/abstract=2412294)

[14] Bhalla, V. K., 2008, Management of Financial Services, (Anmol Publications Pvt. Ltd., New Delhi, India).

[15] Bone, Rosemarie Bröker, 2010, Determinants of corporate ratings in the oil industry: The Repsol-YPF case, READ 16, 70-90.

[16] Bosch, Oliver, and Sascha Steffen, 2011, On syndicate composition, corporate structure and the certification effect of credit ratings, Journal of Banking & Finance 35, 290-299.

[17] Cantor, Richard, 2004, An introduction to recent research on credit ratings, Journal of Banking & Finance 28, 2565-2573.

[18] Chou, Ting-Kai, and Jia-Chi Cheng, 2012, Credit ratings and excess value of diversification, Journal of Empirical Finance 19, 266-281.

[19] Cohen, Gil, 2014, On the impact of bond's rating changes on the firm's stock price, International Journal of Financial Research 5, 64-70.

[20] Creighton, Adam, Luke Gower, and Anthony J. Richards, 2007, The impact of rating changes in Australian financial markets, Pacific-Basin Finance Journal 15, 1-17.

[21] Czarnitzki, Dirk, and Kornelius Kraft, 2004, Innovation indicators and corporate credit ratings: Evidence from German firms, Economics Letters 82, 377-384.

[22] Gordon, E., and K. Natarajan, 1999, Financial Markets and Services, (Himalaya Publishing House, Mumbai, India).

[23] Grunert, Jens, Lars Norden, and Martin Weber, 2005, The role of non-financial factors in internal credit ratings, Journal of Banking & Finance 29, 509-531.

[24] Hartarska, Valentina, and Denis Nadolnyak, 2008, Does rating help microfinance institutions raise funds? Cross-country evidence, International Review of Economics and Finance 17, 558-571.

[25] He, Yan, Junbo Wang, and K.C. John Wei, 2011, Do bond rating changes affect the information asymmetry of stock trading?, Journal of Empirical Finance 18, 103-116.

[26] Kang, Qiang, and Qiao Liu, 2005, Guess who's also minding your business? The effect of credit ratings changes on CEO incentives, in Seminar Proceedings of School of Economics and Finance, University of Hong Kong (HKU, Hong Kong)

[27] Kaur, Kuljeet, and Rajinder Kaur, 2011, Credit rating in India: A study of rating methodology of rating agencies, Global Journal of Management and Business Research 11, 62-68.

[28] Kisgen, Darren J., 2006, Credit ratings and capital structure, The Journal of Finance 61, 1035-1072.

[29] Korkeamaki, Timo, Salla Poyry, and Maiju Suo, 2014, Credit ratings and information asymmetry on the Chinese syndicated loan market, China Economic Review 31, 1-16.

[30] Kumar, K.S Venkateswara, and S. Hanumantha Rao, 2012, Credit rating- Role in modern financial system, International Journal of Marketing, Financial Services & Management Research 1, 126-138.

[31] Murcia, Flávia Cruz de Souza, Fernando Dal-Ri Murcia, Suliani Rover, and José Alonso Borba, 2014, The determinants of credit rating: Brazilian evidence, Brazilian Administration Review 11, 188-209.

[32] Papaikonomou, Vassiliki L., 2010, Credit rating agencies and global financial crisis: Need for a paradigm shift in financial market regulation, Studies in Economics and Finance 27, 161-174.

[33] Roje, Gorana, 2005, The role of accounting determinants in predicting long term credit ratings, in Proceedings of the European Accounting Association Congress (Gotheborg, Sweden).

[34] Roy, Patrick Van, 2006, Is there a difference between solicited and unsolicited bank ratings and if so, why?, Working paper no. 79, National Bank of Belgium.

[35] Standard & Poor's, 2010, Guide to credit rating essentials (http://www.unite.it/UniTE/Engine/RAServeFile.php/f/File_Prof/MALAVOLTA_1250/SP_CreditRatingsGuide.pdf).

[36] Venkiteshwaran, Vinod, 2014, Do asset sales affect firm credit risk? – Evidence from credit rating assignments, Managerial Finance 40, 903-927.

[37] Xia, Han, 2014, Can investor-paid credit rating agencies improve the information quality of issuer-paid rating agencies?, Working Paper, The University of Texas at Dallas.