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The Role of Credit Ratings on Capital Structure and its Speed of Adjustment in Bank-Oriented and Market-Oriented Economies

Abstract

This study investigates both the direct and indirect roles of credit ratings on the capital structures of firms operating in 20 countries with different financial orientations and levels of development. There is ample evidence showing that in capital market-oriented economies (Australia, Canada, Hong Kong, South Korea, Mexico, the Netherlands, Sweden, Switzerland, Taiwan, Thailand, the U.K., and the U.S.) having a credit rating helps firms issue equity or corporate debt. In bank-oriented economies (France, Germany, India, Indonesia, Italy, Japan, Russia, and Spain), companies tend to obtain loans from banks with which they maintain a long-term relationship. The creditworthiness of the firms is thus assessed by banks without much need for external credit ratings. Using data from 1,704 non-financial firms over the 1991-2010, I find that a credit rating's impact on capital structure is much stronger in market-oriented and industrialized economies, as compared with bank-oriented and developing economies. The results are robust across different estimation techniques. The results also show that the roles of firm size and asset tangibility, which I use as proxies for bankruptcy cost, are mitigated by credit ratings. Finally, this paper confirms that non-rated firms have slower capital structure adjustments than their rated peers and a better credit rating is associated with a faster speed of adjustment towards a desired level of gearing not only in market-oriented countries, but also in those that are bank-oriented.

Keywords: credit ratings, financial orientation, capital structure, speed of adjustment