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Does good governance matter to debtholders? Evidence from the credit ratings of Japanese firms

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ABSTRACT

Consistent with existing evidence based on US firms, we show that good governance is associated with higher credit ratings. The most significant variables are institutional ownership and disclosure quality. This finding suggests that active monitoring (by large shareholders) and lower information asymmetry (through better disclosures) mitigate agency conflicts and reduce the risk to debtholders. Credit ratings are also found to increase with board size, consistent with a moderation effect in large decision-making groups. As a rule, firms are expected to benefit from better governance by being able to access funding at a lower cost and in larger amounts.

1. Introduction

The separation of ownership and control in public corporations is a source of agency conflicts whereby managers entrusted with decision-making authority make choices in their own interest rather than in the interest of investors. More often than not, managers choose to invest in projects that require less effort and pose a lower risk to their human capital even though these projects tend to be associated with lower returns (Fama, 1980; Holmstrom, 1999; Bertrand and Mullainathan, 2003).

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Equity compensation and active monitoring can mitigate these agency conflicts (Smith and Stulz, 1985; Dechow and Sloan, 1991; Wright et al., 2007). For instance, large shareholders are perceived to be more effective because of their greater incentives to monitor management (Shleifer and Vishny, 1986; McConnell and Servaes, 1990). Greater distinction between management and monitoring responsibilities, through the use of independent directors, should also improve management accountability and result in better corporate decisions. By and large, good governance involves organizational structures that help reduce agency conflicts by increasing the incentives to select good decisions and deterring choices that damage firm value. It logically follows that the risk to investors should be lower. In particular, good governance is likely to infuse greater confidence among debtholders that the firm will not make decisions that hurt their interests.

The empirical evidence regarding US firms supports the idea that good governance is highly valued by participants in the credit markets. Bhojraj and Sengupta (2003) show that effective monitoring (proxied by the percentage of institutional ownership) and board independence (proxied by the proportion of outside directors) have a positive influence on credit ratings and a negative influence on bond yields. Ashbaugh-Skaife et al. (2006) confirm that credit ratings are positively related to the level of institutional and board ownership. Greater disclosure and transparency (proxied by the timeliness of earnings) are also found to have a positive impact on credit ratings. Anderson et al. (2004) emphasize that board size and financial expertise are associated with a lower cost of debt. The size and independence of the firm's audit committee are also found to have a negative impact on the firm's cost of debt. On the other hand, Klock et al. (2005) show that anti-takeover provisions which are normally indicative of poor governance contribute to lower the firm's cost of debt because they allow managers to pursue low-risk strategies.

The objective of this paper is to investigate whether good governance is associated with higher credit ratings in Japan. We use credit rating data from Rating and Investment Information Inc. (R&I), the leading credit rating agency in Japan, and one of the few companies qualified in the US as Nationally Recognized Statistical Rating Organization (NRSRO). Our governance data is provided by Nikkei Corporate Governance Evaluation System (CGES). The data contain some detailed information regarding the firm's board and shareholding structures, as well as the quality of its disclosure practice, which have not been exploited in previous literature. Hence, the data allow us to examine which governance attributes have the strongest impact on credit ratings, and which governance attributes have a less significant influence. In addition, we investigate whether the benefits of good governance are adequately reflected in the firm's credit rating by looking at changes in each firm's rating and credit quality over the next 5 years.

Our findings reveal that good governance affects a firm's ability to raise funds at a lower cost. More precisely, higher institutional ownership and greater transparency are associated with higher credit ratings. This might be because large institutions infuse the sense that managers are better monitored. Likewise, greater transparency suggests that managers have less freedom to conceal poor decisions. Prompt corrective actions can thus be taken, which should reduce the risk to debtholders. Board size also appears to be viewed favourably. While larger boards may be subject to coordination problems (Lipton and Lorsch, 1992; Jensen, 1993), they also provide more resources and allow greater flexibility for board members to perform their tasks (Pfeffer and Salancik, 1978; Fama and Jensen, 1983; Raheja, 2005). In addition, larger boards are likely to make less risky investments since greater moderation in groups and diversification of opinions contribute to weed out mistakes that occur more frequently in smaller decision making groups (Cheng, 2008; Adams and Ferreira, 2010).

In contrast, board ownership and independence appear to have little impact in contrast to the evidence based on US firms. This should not come as a surprise since Japanese boards are essentially composed of insiders (Sarra and Nakahigashi, 2002; Liu et al., 2011; Aman and Nguyen, 2012). In fact, more than half of all publicly-listed firms have no outside directors sitting on their boards. In these conditions, it is not hard to figure out that the number (or proportion) of outsiders is unlikely to provide any assurance that the firm is better monitored. Similarly, board ownership is not necessarily viewed favourably by debtholders. On one hand, it provides incentives to take better actions and may deter managers from taking excessive risks. But, on the other hand, it can exacerbate the agency cost of debt (risk shifting) when the firm is in financial distress. Hence, debtholders may not view board ownership as being beneficial to their interests.