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Do credit rating concerns lead to better corporate governance? Evidence from Korea☆

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ABSTRACT

We study the 1997 Asian financial crisis to show that credit rating concerns affect firms' corporate governance. We treat the crisis as an exogenous shock that led to improvements in the informativeness of Korea's credit rating system, and we determine that credit rating concerns affect corporate governance following the crisis but not before the crisis. Moreover, this effect is concentrated in firms that are in chaebol business groups, consistent with their increased dependence on external financing. Finally, we find that firms that were particularly affected by the reforms demonstrate an increased reliance on debt that is dependent on credit ratings, consistent with our hypothesized effects of this exogenous shock. Our paper presents a novel approach to evaluating whether managers would improve their firms' corporate governance in response to their credit rating concerns, and it highlights the wide-ranging effects of reforms that are implemented due to financial crises.

1. Introduction

Although credit ratings enable investors to make use of rating agencies' expertise in evaluating financial securities, credit ratings have also been demonstrated to affect the activities and management of firms. For example, Kisgen (2006) shows the effects of credit rating concerns on capital structure, presenting evidence consistent with the discrete costs and benefits of rating changes. Hovakimian et al. (2009) and Kisgen (2009) provide evidence of credit rating "targeting." Begley (2013) shows that firms distort their real investment activities to improve their credit ratings, resulting in lower innovation, profitability, and Tobin's Q. Recent evidence (Alissa et al., 2013; Jung et al., 2013) indicates that firms manage earnings with the goal of managing their credit ratings. Additionally, surveys and interviews (Graham and Harvey, 2001; Graham et al., 2005) confirm the important effects that credit rating concerns have on managers' actions. Although these earlier studies suggest potentially pernicious effects of managers' credit rating concerns in distorting firm capital structure, investment activities, and financial reporting activities, we present evidence

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that credit rating concerns have a beneficial aspect by providing an incentive for managers to improve their firms' corporate governance.

To the degree that credit ratings are affected by firms' governance (Ashbaugh-Skaife et al., 2006; Moody's Investors Service, 2006), it is reasonable to expect that managers with credit rating concerns will improve their corporate governance to secure higher credit ratings. Credit ratings are thus one of several possible ways to facilitate corporate governance improvements. The lack of research in the linkage between corporate governance and credit ratings is primarily due to the difficulty of addressing reverse-causality. To address this issue, we examine the shock to the reliability and validity of firms' credit ratings in Korea following the 1997 Asian financial crisis. By exploiting the exogeneity of the improvements in the credit rating system, we can more effectively address causality.

Prior work has documented an association between credit ratings and corporate governance. For example, Ashbaugh-Skaife et al. (2006) find evidence that credit ratings are positively associated with high levels of corporate governance. Specifically, the movement of a firm from the lower to the upper quartile of its corporate governance variables doubles the probability of that firm having an investment-grade credit rating. Their evidence further suggests that some firms continue to operate despite the effects of weak governance on the firm value because of the managers' ability to extract rents in poorly governed firms. Moody's Investors Service (2006) notes that corporate governance is often a driver of credit ratings. Similarly, Alali et al. (2010) show that an improvement in corporate governance is associated with improved bond ratings.

In our paper, we extend these earlier studies by showing how a firm's credit rating concerns affect its corporate governance. Our paper also addresses endogeneity concerns by analyzing the exogenous changes to the credit rating system's informativeness that occurred following the 1997 Asian financial crisis. Given a reliable credit rating system, we would expect the managers of firms near credit-rating upgrades or downgrades to improve their firms' governance to signal their firms' strengths to the market (or to mitigate outside parties' concerns with their firms). Doing so would enable them to eventually raise capital with more appealing terms in the future. In contrast, we would not expect this effect when the credit rating system is unreliable.

Studying these wide-ranging effects of reforms that were implemented due to the Asian financial crisis is relevant in light of the 2008 financial crisis. Many of the regulatory reforms that were implemented in response to the crisis affected credit rating informativeness (and thus managers' credit rating concerns). For example, in the United States, the Dodd–Frank Act repealed Rule 436(g) of the Securities Act of 1933 (which increased rating agencies' liability in certain circumstances), deleted rating agencies' exemption to Regulation Fair Disclosure, and removed the reliance on external credit ratings from certain US regulations.[1] To the degree that these reforms may reduce the informativeness and relevance of credit ratings, it is plausible for these reforms to have additional effects on managers' credit rating concerns. Consequently, because our study highlights wide-ranging effects of increased transparency and financial statement informativeness, it is reasonable to similarly expect wide-ranging effects of recent regulations.

Firms in Korea adopted various corporate governance improvements following the 1997 Asian financial crisis. One of the effects of the governance reforms was increased influence and informativeness of credit ratings. However, there is no reason to expect that our measure of credit rating concerns (i.e., firms close to rating upgrades or downgrades) would otherwise drive the improvements in corporate governance—or to expect that the relation would only be concentrated in those firms close to rating upgrades or downgrades. We are thus able to exploit a relatively natural experiment that affected firms with notched credit ratings following the financial crisis. Consequently, the specifications employed in our study control for any contemporaneous improvements in governance following the financial crisis.

Korea improved both its internal and external monitoring systems in the aftermath of the 1997 Asian financial crisis (see, for example, Black and Kim, 2012). This, in turn, drove an increase in the reliability and importance of credit ratings. In particular, Korea significantly improved monitoring through reforms such as the dissolution of cross-debt guarantees, weakened restrictions on hostile and foreign mergers and acquisitions, improved auditing systems, and increased the voting rights of institutional investors (Lee, 2011). These governance reforms also increased the prominence of external directors. Choi et al. (2007) note the positive effect of outsiders, such as independent directors and foreign investors, on firm performance. Similarly, Garner and Kim (2013) highlight the role of foreign shareholders in improving firms' corporate governance. These results are consistent with external stockholders moderating the ability of managers to engage in rent-seeking (Shleifer and Vishny, 1997). As a result of these improvements in disclosure and monitoring, which in turn improved the informativeness of the credit rating system, exploiting the changes that occurred following the financial crisis gives us an opportunity to test the effects of credit rating concerns on firms' corporate governance decisions.

Indeed, we find that in the post-crisis period, firms near rating upgrades or downgrades are associated with improved corporate governance, suggesting that credit ratings affect corporate governance. The firms we expect to be especially concerned with their credit rating levels exhibited an approximately 1.3% increase in ownership of their owner-managers (the controlling shareholders).[2]

[1] Dimitrov et al. (2015) discuss the effects of the Dodd–Frank Act on credit ratings. The focus of the Dodd–Frank Act's reforms was different from those that occurred in Korea, which we discuss in more detail in Section 2.2.

[2] We use the change in ownership of firms' owner–managers (i.e., controlling shareholders) as an estimate of the change in firms' governance, following from Leland and Pyle (1977), Joh (2003), Baek et al. (2004), and Gormley et al. (2015). This measure is particularly appropriate as a measure of corporate governance among Korean firms, given the significant influence of owner–managers on the firm's operations and the limited influence of institutional investors or an active takeover market. Additionally, in contrast to measures such as the "wedge" or "ratio" of voting rights and cash-flow rights, our measure does not suffer from reflecting the propensity of the owner–manager to engage in tunneling.