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An empirical examination of the informational content of credit ratings in China ☆

Winnie P.H. Poon [a], Kam C. Chan [b,*]

[a] Department of Finance and Insurance, Lingnan University, Hong Kong
[b] Gordon Ford College of Business, Western Kentucky University, Bowling Green, KY 42101, United States

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Abstract

We examine the certification effect of initial rating announcements and the signaling effect of rating downgrade announcements in China using a pooled time-series cross-sectional issuer rating data of 170 companies listed on the Shanghai and Shenzhen Stock Exchanges from 2002 to July 2006. The empirical evidence supports our hypothesis of an asymmetric certification effect. Consistent with the literature, we also find some negative signaling effects in our rating downgrade sub-sample. Overall, although there are some qualitative arguments that credit ratings in China do not have information content, our empirical findings suggest otherwise. When a normally positively biased rating agency gives a low rating, it is valuable news to market participants.

JEL classification: G0; G1; G2
Keywords: Credit ratings; Informational content; China

1. Introduction

Bottelier (2003) describes the debt markets in China as "relatively narrow, illiquid and segmented" and they fell behind equity markets despite the rapid growth of government bond issues in recent years. Tan and Chung (2004) also consider China's corporate bond market to be underdeveloped. Well-developed bond markets are also becoming more important in China as the number of institutional investors in China grows and they become more sophisticated and attempt to play a larger role in China's bond market. These institutional investors have strong demands for more debt instruments and this, in turn, will generate a demand for credit ratings that truly reflect an issuer's default risk.

Lee (2006) and Asiamoney (2006) argue that China's debt securities markets are being impeded by the lack of high quality independent credit-rating services. Both Lee and *Asiamoney* claim that major Chinese credit-rating agencies have put too much emphasis on winning business by giving top ratings to most issuers, whether top ratings were deserved or not. For example, the online credit-rating reports of Dagong Global Credit Rating Co., Ltd. (Dagong) show that all 29 companies in Dagong's sample received credit ratings of A or above and 21% of the companies obtained AAA credit ratings (Dagong, 2006). In essence, none of Dagong's sample companies carries a speculative-grade credit rating. Most notably, Dagong assigns the highest AAA bond ratings to all the bond issues in its sample (Dagong, 2006). Similarly, China Chengxin International Credit

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* Corresponding author.
E-mail addresses: winpoon@LN.EDU.HK (W.P.H. Poon), johnny.chan@wku.edu (K.C. Chan).

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Rating Co., Ltd. (CCXI) has never assigned a speculative-grade rating on any of the short-term corporate debt issues it covers (Asiamoney, 2006).

Bottelier (2003) also finds that most listed corporate bonds in China received AAA credit ratings from the major domestic rating agencies. He argues that the four domestic credit rating agencies, CCXI, Dagong, China Lianhe Credit Rating Co., Ltd. (Lianhe) and Shanghai Far East Credit Rating Co., Ltd. (SFE), are not truly independent and their ratings are irrelevant in the market. Kennedy (2003) also suggests that these domestic rating agencies have no apparent impact on the decisions of corporate bond buyers in China and the market attaches little credibility to their ratings.

Although the independence and objectivity of China's credit rating agencies are being questioned, Larry Lee, the long-time chief at Fitch Ratings Ltd. (Fitch), believes that Chinese investors do care about credit ratings if they are from good rating agencies (Asiamoney, 2006). In fact, not all Chinese rating agencies are under pressure from issuers to provide sky-high credit ratings. The Xinhua Financial Network (XFN) of Xinhua Finance in Hong Kong and SFE in Shanghai formed a strategic alliance called "XFN-Far East China Credit Rating" (Xinhua-Far East) in 2002 to conduct credit rating analyses (SFE, 2004). Xinhua-Far East employs international rating standards (Asiamoney, 2006) and its recent issuer rating results seem to be consistent with the results of global rating companies. For example, in contrast to Dagong's rating results for similar time period mentioned above, Xinhua-Far East's results show that only less than 5% of the Chinese listed companies in its sample received AAA credit ratings and 23% of these companies obtained speculative-grade credit ratings in November 2006 (Xinhua-Far East, 2006).

In sum, there are many questions on the value of China's credit ratings to investors, despite the urgent need for high quality credit ratings in the emerging Chinese financial markets. The purpose of our study is to examine the informational content of domestic credit ratings on stock returns in China using a sample of issuer ratings from Xinhua-Far East during the period 2002 to 2006. Specifically, we focus on two possible effects: (1) the certification effect of initial ratings on stock returns (e.g., Beaver et al., 2006), and (2) the signaling effect of rating changes on stock returns (e.g., Holthausen and Leftwich, 1986; Goh and Ederington, 1993). Although many critics suggest that Chinese credit ratings do not have any significant effect on the decisions of investors, they provide no robust empirical evidence to support their claims. We contribute to the literature by providing an in-depth empirical research into Chinese credit ratings and their impact on stock returns. Decomposing the sample into investment and speculative grades, we find that when a normally positively biased rating agency gives a low rating, it is valuable information to investors. In addition, our findings suggest that Xinhua-Far East is found to display the certification and signaling effects. Hence, Xinhua-Far East is the only firm that can have these effects since they are the only firm to rate some debts as speculative, and that the market is efficient enough to react to the news.

2. Background to the research

This section provides background information on the regulatory framework and recent developments in the credit rating industry in China. It also discusses selected studies of credit ratings.

2.1. Background and regulations for the credit rating industry in China

Credit ratings in China were initiated in 1987 when the State Council issued the "Temporary Regulations on the Management of Corporate Bonds" (Harrison, 2003; Kennedy, 2004). This prompted provincial branches of the People's Bank of China (PBOC) to create credit rating departments. These rating departments then evolved into independent credit rating firms, and other rating agencies emerged in subsequent years (Kennedy, 2003, 2004). The temporary regulations were effective until the release of the "Regulations on the Management of Corporate Bonds" (or the "Corporate Bond Regulations") on August 2, 1993 (State Council, 1993). Since 1994, the PBOC has promulgated regulations that stipulate which listed bond issuers and bank loan borrowers must obtain credit ratings (China Daily, 1998a). On December 16, 1997, in an attempt to create more consistency in the rating industry, the PBOC announced that all corporate bond issuers had to obtain credit ratings from PBOC-approved rating agencies before issuing bonds (PBOC, 1997; and Kennedy, 2003). The number of qualified rating agencies was restricted to nine by the PBOC in late 1997 (Tan and Chung, 2004).

Recently, the China Securities Regulatory Commission (CSRC) prepared a draft report "Measure on Regulating the Securities Credit Rating Business." This move from the CSRC was an effort to formalize the accreditation process for credit rating agencies to set standard criteria for minimum asset requirements, rating experience, rating systems, and to prohibit certain activities (Kennedy, 2003). To our knowledge, the final version of this regulation was not yet available to the public as of January 2006.

2.2. Recent developments in the credit rating industry in China

There are about 20 domestic rating agencies (nine of them are PBOC-qualified/recognized agencies) in China, but most of them are small and lack advanced technology (China Daily, 1998b). The major players in China's domestic corporate bond business are SFE, CCXI, Dagong, and Lianhe (SFE, 2004; CCXI, 2004; Dagong, 2004; Lianhe, 2004; and Kennedy, 2003). XFN of Xinhua Finance in Hong Kong and SFE formed a strategic alliance (hereafter, Xinhua-Far East) to conduct credit-rating analyses in 2002 (SFE, 2004).

In addition to local rating agencies, the top three international rating agencies—Moody's Investors Service (Moody's), Standard and Poor's Ratings Services (S&P's), and Fitch—have approached the nascent credit rating industry in China in recent years. Fitch formed a joint venture with China Chengxin Credit Management Co., Ltd. (CCX) in 1999 but divested from this