Report on the use of funds and outcomes of the Project Foreign Ownership in Chinese Credit Ratings Industry: Information Revelation or Certification?

Project Title: Foreign Ownership in Chinese Credit Ratings Industry: Information Revelation or Certification?

WBS: RE-04038

ResearchMaster Code: 0200319527

(1) Name, Position, Contact Details for each applicant

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(2) Project Title

Foreign Ownership in Chinese Credit Ratings Industry: Information Revelation or Certification?

(3) Updated Project Summary (500 words) including any variations between the project undertaken and the original application

There are no major changes between the project undertaken and the original application.

Summary: We investigate the informational roles of foreign ownership in local credit rating agencies (CRAs) in the Chinese onshore debt market, which was the world's largest emerging debt market from 2008 to 2017. We find a robust negative relationship between the bond offering yield and foreign ownership in local CRAs, which suggests that these ratings certify the credit quality of debt issuers and thus enhance the market values of new debt issues. The information content of these ratings, however, is in contrast with the information provision role of foreign-owned CRAs (global CRAs). We find that these ratings provide no or weak better predictive power of issuers' future credit performances than domestic CRAs. In addition, we find that stock and bond market reactions at the announcements of rating revisions made by global CRAs are not significantly different from those made by their domestic counterparts. We attribute the seemingly contradictory results to the preference for foreign brands in emerging markets and/or the improved bond liquidity associated with global CRA ratings.

(4) Funds Granted

AUD $2,000

(5) Detailed Report on Expenditure of Funds against Budget Items, with variations explained

The $2,000 budget was spent on hiring a research assistance to collect fundamental and market data, as well as merge the bond issuers' information to stock market data.

There is no variation between the original budget and the actual expenditure.

Also see attached report issued by the finance team.

(6) Outcomes, for example, working papers, presentations and publications (give full details, including abstracts)

Publication: The paper is published on Journal of Banking & Finance (ABDC A*).

Hu, X., Shi, J., Wang, L. and Yu, J., 2020. Foreign ownership in Chinese credit ratings industry: Information revelation or certification?. Journal of Banking & Finance, 118, p.105891.

Abstract: We investigate the informational roles of foreign ownership in local credit rating agencies (CRAs) in the Chinese onshore debt market, which was the world's largest emerging debt market from 2008 to 2017. We find a robust negative relationship between the bond offering yield and foreign ownership in local CRAs, which suggests that these ratings certify the credit quality of debt issuers and thus enhance the market values of new debt issues. The information content of these ratings, however, is in contrast with the information provision role of foreign-owned CRAs (global CRAs). We find that these ratings provide no or weak better predictive power of issuers' future credit performances than domestic CRAs. In addition, we find that stock and bond market reactions at the announcements of rating revisions made by global CRAs are not significantly different from those made by their domestic counterparts. We attribute the seemingly contradictory results to the preference for foreign brands in emerging markets and/or the improved bond liquidity associated with global CRA ratings

Presentation:

- 2019 Financial Markets and Corporate Governance Conference
- 2019 Asian Finance Association Annual Meeting
- Research seminars at Macquarie University
- Research seminars at RMIT University
- Research seminars at Xi'an Jiaotong University
- Research seminars at Shandong University of Finance and Economics
- Research seminars at Sichuan University

(7) Future Intentions for this Project (give full details) a. Conference submissions b. Journal submissions c. Grant applications d. Projects

The project has been published, and there are no future intentions for this project.

(8) Summary of Outcomes and Benefits

To assess the two informational roles of global CRAs (information certification and revelation, we investigate the following three research questions: (1) How do global CRAs affect the offering prices of bonds? (2) Can global CRA ratings predict the expected and realized default risks of corporate bond issues? and 3) Do global CRA ratings reveal information that the public does not have access to?

We contend that the credit ratings provided by reputable information certifiers do not necessarily reflect the true quality of issuers. Our empirical tests reveal several intriguing findings. Focusing on two CRAs partially owned by Moody's or Fitch as global CRAs, the initial analysis yields results consistent with the work of Livingston, Poon and Zhou (2018). Holding all else equal, the offering yield spread of debt issues rated by global CRAs is, on average, 4.8 basis points lower than those rated by pure domestic CRAs. We also systematically examine the information content of credit ratings by global CRAs. This analysis clarifies the differentiation between the certification and information revelation effects of reputable global CRAs. We apply the expected default probability (EDP) measure derived from the Merton (1974)/KMV model and the modified Z score for Chinese firms (ZChina) as two alternative credit risk proxies. Based on EDP, we find no significant association between global CRA ratings and firm credit risk; there is only weak evidence supporting the informativeness of global CRA ratings based on ZChina. Finally, we inspect the limited number of actual debt default events for bonds rated by domestic and global raters. There is some evidence that global CRA rated bonds have a greater default ratio than those rated by domestic counterparts, when controlling for bond credit ratings. The overall evidence casts doubt on the information content of global CRA ratings, despite their certification benefits to debt issuers.

We also examine whether global CRAs gain access to private information in China's debt market by investigating the stock and bond market reactions around credit ratings revisions. There are 859 rating revisions until June 2019 (215 downgrades and 644 upgrades), among which, global CRAs made 129 downgrades and 322 upgrades. Interestingly, we do not observe any significantly different market reactions toward ratings revisions made by global CRAs from those made by domestic CRAs, which corroborates the previous tests on the information quality role of global CRAs.

Finally, we make an attempt to reconcile the disconnection between the information certification effect and the lack of information revelation effect of global CRAs with two non-mutually exclusive explanations. Drawing on the marketing literature (Klein, Ettenson, and Morris, 1998; Pappu, Quester, and Cooksey, 2007), the seemingly conflicting effects could be rationalized by the emerging market consumers' preference for foreign brands. Additionally, we observe the improved market liquidity associated with global CRA rated bonds, which could also explain the reduced offering yield spreads of these issues.

Our research makes a significant contribution to a broad literature that studies the certification and informational role of credit rating agencies. A large majority of these studies concentrate on the well-developed U.S. credit market. Our study makes a deliberate departure from the U.S.-centric research and leans on an emerging strand of literature that examines how foreign ownership in CRAs affects the cost of debt and the rating quality in non-U.S. settings (Li, Shin, and Moore, 2006; Han, Pagano, and Shin, 2012; Ferri, Lacitignola, and Lee, 2013). Distinct from prior work, we study the connection between the certification effect and information content of credit ratings from global CRAs in a large emerging debt market, i.e., China. Two recent studies on China's credit ratings are closely related to ours. Livingston, Poon and Zhou (2018) investigate the determinants of bond credit ratings for nonfinancial corporate bonds in China from 2009 to 2015. They find that bond issues rated by CRAs that have partnerships with the Big Three rating giants enjoy better offering prices. Jiang and Packer (2019) compare the credit ratings by domestic CRAs in China's onshore debt market and ratings provided by the Big Three CRAs in the international debt market for the same set of Chinese issuers. Both studies focus on the certification effect of global CRA ratings at bond issuance.

Our study extends these studies and examines the quality of global CRA ratings through various credit risk measures, as well as stock/bond market responses to their rating revisions post debt issuance. We explore the information content of global CRA ratings using a comprehensive list of credit rating quality measures over an extended sample period. As a byproduct of our findings, we validate the use of EDP and Z score measures among Chinese firms using the actual bond default events since 2014.

This study also adds to the literature on the role of foreign investors in emerging markets. Some advocates believe that foreign investors have more advanced skills and technologies (Grinblatt and Keloharju, 2000; Seasholes, 2000) while others argue for the private information sources available to local investors (Brennan and Cao, 1997; Choe, Kho, and Stulz, 2005). We generate further evidence by examining how foreign ownership affects the information environment in the credit rating industry. We are able to disentangle the information certification role from the information revelation role of foreign ownership in CRAs in the Chinese debt market. Although foreign stakes in local CRAs signal the quality of the issuers and lower the offering bond yield, their ratings do not perform any better in forecasting future default risk. This sharply contrasts with the market perception of their reputational capital during debt issuances.