CHAPTER V

Conclusion and Recommendation

5.1 Conclusion

This thesis extend the study of credit rating effect on firms' capital structure into G7 nations and provide the empirical evidence of using probability of default in place of credit rating. The test on credit rating effect is divided into 2 parts, broad rating test and micro rating test, followed by testing on probability of default effect on firms' capital structure, and the incorporating these factors into the context of capital structure theories, trade-off, pecking order, and market timing theory.

The empirical result shows that broad rating test which use rating's plus and minus sign to tell that firm will make some change in their capital structure has reduce in its explanatory power. These agree with the result from Kisgen (2006) itself that is from year 1996 and so on, plus or minus dummy variable seem not able to explain the firms' capital structure decision. For micro rating test, the empirical evidence shows that at this level it also can not be used to explain the debt issuing. These show the decreasing in the confidence of credit rating and firm rating. Probability of default form last year is used as the determinant of firms' capital structure and the empirical result shown that it works. With negatively significant at 1% confidence level, firms' last year probability of default shows that it has explanatory power in explain the firms' capital structure decision, firms with high probability will be more likely to reduce their use of debt.

Next, the incorporating credit rating and probability of default into the context of capital structure theories, pecking order, trade-off, and market timing theory. Pecking order theory is insignificant implies that most firms do not issue securities orderly as pecking order mention, while the trade off theory is exist. Market timing is also not exist, firms do not issue it securities by observe the change in market value of its stock. The plus or minus and high or low dummy variable both insignificant implies the decrease in its explanatory power and the confidence of credit rating and rating agencies. The result show that probability of default have the explanatory power which can be explained by the firms concern on its debt level, the high debt level the high probability of default then it lead to the reduction of debt level in order to keep the firm away from financial distress situation.

5.2 Recommendation

This paper shows the empirical evidence of credit rating and probability of default effect on firms' capital structure in G7 nations. The explanatory power of credit rating seem to reduce, both in broad rating and micro rating, it is no longer be used in explain the capital structure. This can be caused by the collapse of Enron which bring to the reduction of confidence and many criticize on rating agencies. The probability of default can be used in the place of credit rating. This paper shows the empirical evidence that probability of default can be use as the determinant of firms' capital structure and it also be able to explain together with the trade-off theory. Future research of capital structure will be benefit in applying Merton's model and probability of default into consideration.