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The Impact of Credit Rating on Cost of Debt: Evidence from Financial Sector in Sri Lanka

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Abstract

Introduction: Credit rating assessment involves the evaluation of the creditworthiness of an individual, company, government, or other entity. The current study identifies the dynamics between credit ratings and the cost of debt. This study aims to empirically investigate the impact of credit rating on the cost of debt in the Sri Lankan financial sector.

Methodology: The methodology employed in this study is deductive and quantitative. The study is based on Secondary data from 12 banks and 11 diversified financial companies listed on the Colombo Stock Exchange. The study is quantitative research, which uses a deductive approach. Cost of Debt is used as the dependent variable, whereas Credit Rating is the independent variable of this study and is used through the Fitch Ratings. The data was collected from 2017 to 2022. STATA version 13 statistical package data was analyzed using panel data regression.

Findings: The findings depict that the Fitch credit rating is negatively and significantly associated with the cost of debt. Companies with high credit rates were associated with lower costs of debt than companies with low credit rates, as found by the paper using multiple regression techniques.

Conclusion: The study's findings provide policy implications on capital structure for managers in the Sri Lankan setting and other developing economies similar to Sri Lanka, given that external financing plays a critical role in capital structure in the financial sector for publicly traded companies. Further, the findings influence firms to get better credit ratings for a lower cost of debt.

Keywords: Credit rating; Cost of debt; Sri Lanka; Financial Sector